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Divestiture of State Enterprises

An Overview of the Legal Framework

Pierre Guislain



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Pierre Guislain

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FOREWORD

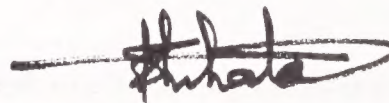
The World Bank's worldwide experience in the privatization of State-owned enterprises (SOEs) in member countries points to the importance of an adequate legal framework for successful privatization and in particular for the divestiture or transfer of ownership of such enterprises to the private sector. This Technical Paper illustrates and develops the critical legal issues that arise at different stages of the divestiture process.

This paper should be useful to lawyers as well as non-lawyers involved in SOE reform in general and divestiture of SOEs in particular. It draws attention to potential problems and attempts to define relevant issues while staying clear of sweeping recommendations and narrow guidelines. It should help practitioners in asking the relevant questions for the preparation and implementation of a divestiture program or transaction and in providing advice adapted to the specific circumstance.

The paper recommends a pragmatic approach to divestiture focussing inter alia on the particular circumstance of the enterprise(s) to be divested, the country's overall environment for private business activity and the government's specific objectives in divesting. It also stresses the role of lawyers in helping structure the overall program as well as the individual transactions.

The World Bank's Legal Department has been providing specialized legal services in the field of privatization as part of the Bank's overall advisory work in this area. Such services focus on general divestiture policy and on improving the legal and institutional framework for private sector development but cannot substitute for the work of government lawyers and private lawyers retained by governments and SOEs for specific privatization programs and transactions.

The author's valuable experience in the Bank's Legal Department and his extensive training in law and economics qualify him well to address the complex legal questions associated with SOE divestiture. His suggestions should be of particular help to those involved in this process in so many countries at present.

A handwritten signature in black ink, appearing to read 'Shihata', with a long horizontal line extending to the left.

Ibrahim F.I. Shihata
Vice President and General Counsel

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This Technical Paper was prepared as a background paper for the report on "Privatization: The Lessons of Experience" which was submitted to the World Bank's Board of Executive Directors in April 1992. The author wishes to thank Mr. Ibrahim F.I. Shihata, Vice President and General Counsel, as well as Messrs. Douglas Webb, Ian Newport, Andres Rigo, Jamil Zouaoui, Peter Ianachkov and Antonio Parra (Legal Department) and Ms. Sunita Kikeri (Country Economics Department) for their support and constructive comments and inputs throughout the preparation of this paper.

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EXECUTIVE SUMMARY

Divestiture, as discussed in this paper, is essentially the process whereby the ownership of assets is transferred from the public sector to the private sector. A State's effectiveness in preparing and managing a divestiture program and private investor perception and response to this program will to a large extent determine the success of divestiture. This has a number of implications for the establishment of a proper legal framework for divestiture. First, laws need to support the divestiture program's overall strategy and policies: the legal and regulatory framework should be designed in a way that maximizes its economic benefits. Second, and in a broader sense, legal reforms should foster a business environment attractive to investors. Indeed, capital is mobile and will tend to go where overall conditions are most favorable. In this context, reducing the level of uncertainty facing private investors interested in participating in a divestiture program should also be a priority objective in the design of a legal enabling environment. Divestiture of State enterprises is thus only in part similar to mergers, acquisitions and divestitures by private companies. The interests of the State as seller may sometimes conflict with those of the State as trustee of the public interest or promoter of economic efficiency. In those cases, the public interest and economic efficiency should generally prevail.

Investors are not the only concerned group. Creditors, labor and management of SOEs (State-Owned Enterprises) as well as civil servants from the oversight ministries will see their position affected by the divestiture process. Lawyers advising the government will have to analyze the extent to which the proposed divestiture program affects the rights and interests of these and other groups, and suggest ways to accommodate or counter them. Divestiture experience in a large number of countries has, for example, highlighted the importance of reforms in labor legislation; failure to address labor issues upfront may delay or even derail a divestiture program. If the government wishes to develop the confidence of the private sector, due regard should be given to safeguarding the rights of SOE creditors in this process. Civil servants and SOE managers will see their influence and possibly their jobs threatened by divestiture. Failure to recognize this may also block the process. Legal and institutional reforms may be in order to give these officials the right incentives to carry out these reforms or to neutralize their obstructive capacity.

Divestiture of State enterprises is a political process managed by the government. Due attention should thus be given to public and administrative law issues, including civil service regulations, accountability of officials, applicable public finance legislation, special public property and public enterprise laws and other public law matters. Setting up a new agency to manage divestiture will similarly have to be done with knowledge of the legal framework which, unless modified, would apply to this agency.

This paper illustrates critical legal issues arising in the context of the transfer of public assets to the private sector, focussing in particular on the sale of SOEs. It underlines the importance of proper legal analysis and inputs at all stages of the divestiture process. Drafting divestiture legislation is rarely the first stage at which legal analysis and inputs are needed. To the contrary, legal analysis is an essential part of the overall diagnostic effort required as a preliminary to the elaboration of a strategy. Legal constraints to divestiture need to be identified and then removed in order to divest successfully.

In this paper we take the reader through the various stages of the development of a legal framework for divestiture, starting with the pre-strategy diagnostic of critical legal issues, moving to an analysis of the overall legal framework for private sector development, and finally to the elements of divestiture legislation *per se* and the role of lawyers in the whole process. Legal issues crop up at every stage and even after the enactment of divestiture legislation and the conclusion of the divestiture transaction. In other words, law permeates the whole divestiture process.

Initially, a wide range of laws, as well as the legal status of the SOEs to be divested, must be analyzed in order to determine whether they allow privatization and are compatible with the government's objectives, or need to be amended, suspended or abrogated to enable or facilitate divestiture. Some SOEs may have a legal status that does not allow or facilitate divestiture, in which case a prior change may be required. Where the ownership of some SOEs or assets is disputed, as may be the case with nationalized enterprises, the rights of contending parties must first be clarified. To be successful, privatization should take place in an overall legal and institutional environment where respect for the rule of law prevails and the rights of private citizens and economic agents, in particular private property rights, are recognized and adequately protected. Discrimination against the private sector, where it exists, will need to be removed and a level playing field created and enforced in the market place.

The nature and investor-friendliness of a country's business laws is a determinant of investment, foreign as well as domestic. A sound legal framework for business activity is bound to facilitate the divestiture process and increase its chances for success. Laws may need to be enacted to abolish a monopoly, protect competition, regulate or deregulate a sector, reduce import and export restrictions, streamline company incorporation procedures, facilitate foreign investment, simplify the tax system, guarantee foreign exchange convertibility and repatriation, or expedite dispute settlement, to name but a few critical aspects of a legal framework for business activity. Furthermore, the applicability of ordinary corporate law techniques to the divestiture transactions envisaged needs to be checked. In this context, liquidation, insolvency, bankruptcy, and capital markets legislation are particularly relevant. This paper illustrates how different parts of a country's legal framework that may not always be directly associated with divestiture may have a far-reaching impact on this process.

Although, optimally, the myriad of laws described in this paper should be in effect to foster private sector development and divestiture, in most developing countries one will have to focus on the core part of the legal framework that must be in place for the divestiture process to succeed. Another approach would lead to endless delays. This constraint should be acknowledged up front. What the core package of legislative reform should be, will depend on the specific situation of each country, including the legal framework in effect at the time, and on the scope and nature of the divestiture program. In a country with unclear property rights, arbitrary law enforcement or overregulated financial markets, to name but a few examples, these constraints may prevent the effective implementation of divestitures; their removal should then be part of the core package of reforms. Similarly, the inclusion of monopolistic enterprises in the list of SOEs to be divested would typically require the enactment of legislation fostering a competitive environment or, in the case of natural monopolies, regulating the monopolist's activities. It is incumbent on the lawyers advising governments to assist them in determining which laws or legal institutions create the most severe bottlenecks for successful privatization in their country.

In other words, identified shortcomings with respect to this idealized environment should first be prioritized. As divestiture is rarely an objective in itself, but rather part of a larger economic reform program seeking a fundamental change in the role of the State in economic activities, priorities will need

to be established consistent with the ultimate objective. Only reforms critical to the success of the divestiture program and consistent with the overall economic reform program should be undertaken.

In establishing such priorities, it is also of the utmost importance to sequence reforms properly. Price and trade liberalization legislation and deregulation should, for example, precede privatization, in particular in countries with stifling licensing requirements, protectionist trade policies and practices and price control systems. Indeed, without the freedom to set prices and operate one's business, few investors would be interested in buying SOEs. If the SOE is nonetheless sold, subsequent price liberalization or deregulation might result in a windfall profit for the investor and accusations that the officials in charge of divestiture sold the SOE below its value, which could damage the whole program. The reverse would often happen were trade liberalization to take place after divestiture. Loss of protection may instantly reduce the value of the privatized enterprise and cause unfair damage to its buyer, and the credibility of the government and its privatization program would be equally damaged.

The proper sequencing of regulatory reform and divestiture also tends to be critical. In order to determine the price they are willing to pay, investors need to know under what regulatory regime the company will be operating. This regime should thus be determined prior to divestiture. Uncertainty with regard to the applicable regulatory regime would result in lower investor interest and sale price. In addition, where a public utility is being divested, investors will not only want to know what the regulatory regime at the time of divestiture will be, but also how it is likely to evolve in the following years. Stability in the regime, backed by a credible undertaking by the government not to substantially modify this regime, or at least not to the detriment of the company, may be essential to attract buyers.

Whether a country should enact specific divestiture or privatization laws or not depends on its political situation, its legal traditions, the extent of the divestiture program and the nature of the enterprises to be divested. Two issues should be distinguished: are legislative enactments needed to authorize or facilitate divestiture, and if this is the case, should these legislative provisions be enacted as amendments to relevant laws or packaged as a specific divestiture law. Some countries have chosen to enact divestiture laws even where divestiture could have been effected without changes in legislation. The advantages of this approach may include up-front and explicit political support and commitment for the process, increased visibility and accountability of the agency in charge of implementing the divestitures, and opportunity to add to the general provisions of the law other changes in the legal regime that may facilitate the divestiture process. The dangers inherent in a divestiture law include lengthy delays needed to secure parliamentary approval, overspecification of the law and excessive parliamentary interference in the process. It should further be noted that SOEs generally do not need special laws to divest their own assets or subsidiaries. The same is often, though not always, true for State holding companies selling subsidiaries or participations in companies.

As a general rule, we would recommend that, where a law is needed, its provisions be limited to the minimum required to privatize efficiently. New legislation would be called for to accommodate what cannot be undertaken, or at least not undertaken efficiently, under the existing legal framework. Many divestiture laws address some of the critical shortcomings in existing legislation mentioned in the previous paragraphs. Such provisions may be referred to as the facilitating provisions of the law, as opposed to its enabling provisions, which deal explicitly with the divestiture process (authorizing and/or organizing it). We would further suggest that what can be done as well or better through lower instruments be handled at such lower levels. This includes not only subordinated or secondary legal instruments, such as implementing regulations, guidelines and decisions, but also contractual agreements negotiated with the buyers.

The divestiture law itself should thus be an enabling law, giving the government or privatization agency broad powers to privatize, while avoiding restrictions that might unduly tie the implementing agencies' hands and delay the process. While flexible, the legal framework should establish basic safeguards guaranteeing the integrity and efficiency of the process. Clear, flexible and competitive divestiture methods carried out in a transparent manner by accountable officials may go a long way to ensure the success of the process.

Finally, one should beware of "legislative optimism". Even if one assumes that the legislator could correctly anticipate the major issues that would arise as part of the implementation of the divestiture program and could thus design an optimal legal framework for divestiture, this would by itself not guarantee success. This legal framework would still need to be applied effectively, which requires that the necessary institutions and capacity exist or be developed and that the individual transactions be

INTRODUCTION

Scope of the Paper

Divestiture objectives, constraints and approaches differ widely from country to country, enterprise to enterprise. This paper presents a general approach for the development of a legal framework for divestiture of State-Owned Enterprises in the industrial and service sectors. It does not discuss divestiture of housing, land or agricultural enterprises. It is in no way exhaustive, nor does it purport to capture all the nuances of specific divestiture experiences. It is neither a blueprint nor a guidebook or technical manual on legal aspects of divestiture. On most of the topics covered, specific legal literature exists to which the reader should refer for further information.

Macro-legal aspects of divestiture are emphasized, while legal issues arising at the transaction level (the micro-legal aspects of divestiture) will only be addressed incidentally¹. Non-legal aspects of divestiture are mentioned only to the extent needed for the purposes of the paper². The focus is thus on the development of an overall legal framework conducive to divestiture. The main purpose of this paper is to increase the legal awareness of officials involved in divestiture programs by providing an overview of the range, complexity and potential significance of legal issues that may be encountered.

Defining Divestiture

For the purposes of this paper, divestiture refers to the transfer of enterprises from the public to the private sector, be it through a transfer of securities (including shares), businesses or other productive assets. It implies a transfer of property rights from a public body (State, government, ministry, public agency, local government, enterprise owned or controlled by the public sector or any other public body) to a private party, whether against payment (sales) or not (e.g. free distribution of shares).

Divestiture is a subset of privatization. Privatization can generally be defined as any measure resulting in the transfer from the public to the private sector of ownership or control over assets or activities. The non-divestiture aspects of privatization will not be discussed. These would include, *inter alia*³: (i) transfer of management control over an SOE without transfer of ownership, such as in the case of management contracts⁴; (ii) contracting out, usually of services previously supplied by the public

¹ A proper handling of the legal aspects of divestiture transactions is of the utmost importance. Indeed, a good overall legal framework would be of little help if transactions were bungled by inexperienced or unqualified negotiators. The myriad of legal issues that may arise in the structuring and negotiations of a divestiture transaction are to a large extent identical to issues arising in the context of private mergers and acquisitions deals. Corporate lawyers tend to be well-equipped to handle such matters in the best interests of their clients.

² See "Privatization: The Lessons of Experience", The World Bank, Country Economics Department, June 1992, for a broader treatment of the topic.

³ See "Private Provision of Public Services, a Literature Survey, Elliot Berg Associates, World Bank mimeo, April 1989.

⁴ See "Management Contracts. Main Features and Design Issues", Sven Olaf Hegstad and Ian Newport, World Bank Technical Paper Number 65, Industry and Finance Series, 1987.

sector⁵; (iii) private provision of services partly funded by public vouchers or other public subsidy programs⁶; (iv) leases of publicly owned enterprises, equipment or assets⁷; (v) Build-Operate-and-Transfer schemes (BOTs)⁸, and other types of concession schemes⁹; (vi) repeal of public monopoly over specific economic activities, such as urban bus transport, or grant of a license to operate regulated services (without concomitant transfer of an SOE or SOE assets), as in the grant of a telephone license or airline route.

Transformation of an SOE into a joint venture through a capital increase subscribed by private parties, and contribution of public assets to the establishment of a joint venture could also be considered as forms of divestiture when the control over these assets, including the right of disposal, is transferred to the private sector. This would normally be the case where, as a result of the transaction, the private sector has a majority on or effective control over the board of the former SOE. Such joint venture agreements will, however, be discussed in this paper only to the extent they include the transfer of shares or other assets from the public to the private sector. Ample literature is available on issues arising in joint ventures between the public and private sectors.

Structure of the Paper

The paper discusses legal inputs in the development of a divestiture strategy (Chapter I), places this strategy in the broader context of a country's overall legal framework for business activity (Chapter II), reviews essential components of public and administrative law and divestiture legislation (Chapter III), and ends with a brief discussion of the role of lawyers in the divestiture process (Chapter IV).¹⁰ Annex I provides a non-exhaustive list of privatization legislation enacted worldwide¹¹, Annex II a selected bibliography¹², and Annex III a lexicon of privatization-related terms.

⁵ In this case, the public body which had been carrying out the activity, now contracts it out to a private party.

⁶ In this case, the contracting party is no longer the public body, but rather the beneficiary (consumer), while the public body finances the services or part thereof.

⁷ If the lease includes an option to buy, it should be considered a form of divestiture, however.

⁸ See "The Build, Operate, and Transfer ("BOT") Approach to Infrastructure Projects in Developing Countries", Mark Augenblick and B. Scott Custer Jr., World Bank, PRE Working Paper WPS 498, August 1990.

⁹ See "An Overview of the French Concession System. A Mechanism for Private Sector Provision of Public Works and Services", Jean-Jacques Lecat, World Bank mimeo, July 1991.

¹⁰ The author wishes to acknowledge the valuable background reports that were prepared for this paper, including reports by Evan Williams and Stephen Franks on the New Zealand privatization experience, Andrew Quale on the privatization of Papelcol, and Javade Chaudhri on legal documentation for privatization transactions (See the bibliography in Annex II for detailed references).

¹¹ As many of these laws and regulations are cited throughout the paper, the reader should refer to this annex for full references.

¹² The reader should refer to this annex for complete references to the articles, books or documents cited in this paper.

CHAPTER I. DEVELOPING A DIVESTITURE STRATEGY

The development of a divestiture strategy is often identified as one of the first steps in the divestiture program. It should rarely be the first step, however. The definition of the key policy objectives driving the government's overall economic program should indeed come first. The divestiture strategy then becomes a sub-strategy, subordinated to the objectives of the overall reform program. Indeed, divestiture is rarely an objective per se. It should be regarded as one instrument of economic policy amongst others.¹³

Setting the Objectives

The definition of divestiture objectives is an important exercise that should take place up-front. Many divestiture programs have drifted for lack of clear objectives or for the simultaneous pursuit of conflicting objectives. From an economic point of view, economy-wide efficiency objectives often dominate the others. In practice, however, setting the objectives tends to be primarily a political exercise. A list of commonly mentioned objectives is provided in Table 1.

The chosen objectives¹⁴ have significant implications not only on the choice and structuring of legal instruments and modalities, but also on the pre-divestiture measures that may need to be taken. In order to achieve the highest levels of efficiency, pre-divestiture reforms will often be called for, covering items such as break-up of the SOE to foster competition, removal of monopolies and other barriers to entry and, in cases of divestiture of natural monopolies, establishing a regulatory framework. For both efficiency and revenue reasons, competitive processes are preferred to direct negotiations with a single investor. In terms of techniques, free vouchers or discounted employee shares would not be the right instruments where revenue maximization is the main objective. Similarly, a public flotation may be the right technique to promote widespread share ownership and the development of capital markets, but may not result in revenue maximization or technology transfers. Mass transfer of shares to all citizens would achieve wide-spread share ownership and, possibly, speed objectives, though not efficiency, revenue maximization, foreign investment or technology transfer objectives.

¹³ Some would argue that divestiture is an objective in itself in the ex-COMECON countries, i.e. countries on the road from a command economy to free markets. I would disagree and consider it as a necessary component of a broader program to establish a market economy. The difference in such countries is that the policy objectives pursued require divestiture, whereas in most other countries divestiture is only one way to achieve a government's objectives.

¹⁴ Together with the adopted timeframe for the implementation of the divestiture process, the scope of the divestiture program (number of enterprises, aggregate value of the program, size relative to the private sector in the economy), target levels for any of these objectives and a variety of other factors referred to later in this paper.

Table 1. List of Divestiture Objectives

Efficiency / Economic Development

- creation of a market economy, the key objective in many reforming socialist economies;
- promotion of macroeconomic or sectoral efficiency and competitiveness;
- promotion of enterprise-level performance, efficiency and competitiveness, including introduction of market discipline, upgrading of plant and equipment, improvement in the level and/or quality of goods and services produced, etc.;
- promotion of competition, including elimination of monopolies;
- development of entrepreneurship and of the private sector in general;
- development of efficient capital markets;
- access to new technologies and promotion of innovation;
- improving access of domestic products to international markets;
- attraction of foreign capital (including for renovation and development of divested enterprises), promotion of foreign investment and/or repatriation of flight capital;
- employment maintenance or creation.

Financial

- maximizing net proceeds of divestiture to generate public revenue needed to fund government expenditures, reduce taxation, reduce the public sector deficit or repay outstanding public debt;
- reduction in the financial drain of SOEs on the State (from subsidies, unpaid taxes, arrears, etc.);
- limiting the commercial risk inherent in the ownership of a business, including the need to provide capital for expansion or to rescue an SOE in financial difficulty.

Distributional

- broader, widespread capital ownership; promotion of "popular capitalism"; development of a national middle class;
- economic development of a particular group in society (e.g. Bumiputeras in Malaysia);
- employee ownership (also for efficiency reasons);
- restoring full property rights of former owners expropriated by previous regimes.

Political

- reduction in the size and scope of the public sector or in its share of economic activity;
- redeployment of public administration efforts from productive to enabling and regulatory activities;
- reducing or eliminating the possibility for a successor government to reverse the divestiture process;
- reducing opportunities for corruption and exploitation of public assets by government officials and SOE managers;
- reducing grip of a party or group (e.g. communist party, nomenklatura, labor unions) on the economy.

The debates around the UK privatization program illustrate the tension between conflicting goals rather well. Many of the larger companies privatized (British Telecom and British Gas in particular) were sold as monopolies or near-monopolies, or with a dominant position in their market (British Airways). Reasons commonly given for this approach included the desire to proceed quickly, to placate SOE managers who otherwise might have obstructed the privatization, to attract large numbers of small shareholders and to maximize sales revenues. Many commentators feel that the Government should have created competition in the concerned sectors prior to divestiture, even at the price of a longer preparation period or lower sales proceeds. Later privatizations, such as the electricity privatizations, were carried out after a prior break-up of the sector had been undertaken in order to create a competitive environment.¹⁵

Not only do divestiture objectives need to be internally consistent, they also need to be consistent with other government objectives. For example, some countries discriminate against foreign investors by barring them from participation in the divestiture program, while simultaneously adopting new foreign investment promotion legislation and sending cabinet members or other high-flying emissaries around the world in quest of fresh foreign investments. Such discrimination against foreign investors in the divestiture law may even be contrary to stipulations of their own foreign investment law.

Setting objectives is not a pure, abstract exercise. Governments tend to have multiple objectives, which may be partly inconsistent. Those will have to be prioritized, preferably with one overriding objective, economic efficiency. Where the overall privatization program has a broader range of objectives, the trade-off between these objectives will have to be made at the transaction level.

In analyzing the legal aspects of divestiture, one always has to go back to the objectives of the divestiture, as most divestiture approaches or techniques are not inherently good or bad, but only better or worse to achieve specific objective(s). The more objectives there are, the more complex the whole privatization process. Room needs to be given to flexibility and discretionary powers as simple formulas cannot be used to address multiple objectives; this makes transparency in procedures and accountability of decision-makers even more important.

Assessing Constraints

Divestiture strategies need to be practical and rest on specific circumstances and characteristics of the country and enterprises concerned. Some of these variables, and in particular their legal dimension, are illustrated below.

Political Constraints

Depending on the specific situation, political constraints can also be analyzed as negative objectives. Indeed, they are often raised to oppose divestiture or limit its scope, and include matters like: (i) the preservation of national sovereignty or independence; (ii) the perceived need to maintain national control over certain activities or strategic interests; (iii) safeguarding the "public interest"; (iv) preventing the concentration of wealth or power in (a few) private hands; or (v) distrust of the private sector or segments thereof. As new laws tend to be a reflection of existing political forces, most of these political

¹⁵ See Yarrow (1986) and Graham and Prosser (1991) at pp. 89 et seq.

considerations determine existing or planned legislation, as illustrated in later sections of this paper. This brief section in no way implies that political constraints are less important, but only that they are outside the scope of this paper. Removing political constraints and developing political consensus and commitment around a privatization strategy are indeed critical to success.

Country Considerations

The political, economic, social, judicial or accounting situation will all have an impact on the willingness of investors to take risks in a specific country. In a country with poor accounting practices, for example, buyers may not want to take over SOE liabilities, and the government may be limited to sale of assets as the sole divestiture technique. Similarly, the absence of organized capital markets may make a public flotation more difficult. In countries with non-convertible currencies, it is in general easier to sell an SOE with foreign exchange earnings than one with local currency revenue only. Eastern Europe provides a good illustration of the difficulty of privatizing SOEs in the absence of a market-based legal and institutional framework. Examples may be found on all continents of constraints to divestiture linked to weak administrative capacity.

Enterprise Characteristics

Legal Status or Form of the SOE

The legal status of SOEs to be divested varies greatly and affects the choice of techniques of divestiture. In many cases, the SOE may need to be restructured ("corporatized") if it is to be sold as a legal entity. This is illustrated with the following examples of SOE forms, ranked roughly by increasing degree of autonomy¹⁶:

Public Law Bodies

- . Government departments or ministries, or parts thereof, without distinct juridical personality;
- . Autonomous entities with their own budget but without separate juridical personality;
- . Government agencies with separate juridical personality;
- . Statutory Corporations, "établissements publics" or Public Corporations, which may be subject in part to private sector laws.

SOEs organized under Private Law

- . SOEs organized under company law, such as a joint stock company wholly owned by the public sector or joint ventures between public entities and private partners (local and/or foreign);
- . SOE subsidiaries organized under private law¹⁷.

¹⁶ The appellation of an SOE form will vary from one legal system or country to another. A same name may refer to different types of enterprises in different countries. What matters is not what the SOE form is called, but what its intrinsic characteristics are.

¹⁷ Whether statutory corporations (enterprises organized under public law) can establish subsidiaries organized under private law depends on the applicable law. In France and countries with a legal system inspired from the French, "établissements publics" are often allowed to establish subsidiaries. This gives them a way to circumvent restrictions placed on public law bodies.

This classification is based on the formal legal status of the SOE, which does not necessarily imply that public law bodies are subject to public law in all aspects of their organization or operations, nor that private law SOEs are in no way affected by public law. One of the critical issues arising out of this classification is whether ownership in the SOE to be divested can be transferred without prior legal transformation (into a joint stock company, for example). Public law bodies are usually set up as such by or pursuant to acts of Parliament and would normally require to be reorganized under company law (i.e. private law) prior to an ownership transfer to the private sector¹⁸. If ownership of the enterprise in its current legal form cannot be transferred, sale of assets and prior corporatization would constitute the two main approaches.¹⁹ The legal status of an SOE may have an incidence on the applicability of many other types of laws, such as labor, social security or tax laws.

Market Structure

Legal and economic issues are closely intertwined in privatization. The analysis of market structure, for instance, can be primarily an economic or a legal matter. The latter will be the case when the specific market's structure is specified by law, as with legal monopolies, where the law makes it illegal for anybody besides the monopolist to engage in specified economic activities.

Where increased efficiency is the primary objective of the divestiture, a monopolistic SOE should to the extent possible be restructured prior to divestiture, either by dividing the SOE in several competing entities or by removing any provisions in laws or regulations creating the monopoly position, preventing or seriously restricting the entry of new businesses into the protected sector. Alternatively, if it is impracticable or not desirable to eliminate the monopoly prior to divestiture, laws must be enacted to regulate the conduct of the enterprise once it has been sold. These laws may be either in the form of general conduct regulations prohibiting uncompetitive behavior (e.g. general competition law, as in New Zealand) or industry-specific regulation of pricing and other critical aspects of the monopolist's activities²⁰.

Sector of Activity

In addition to the traditional problems of market structure referred to above, sector specific characteristics may affect the divestiture. The divestiture of a telephone company, for example, should be tailored to a certain extent in function of the worldwide nature of the industry, which is dominated by national or regional monopolies. This means (i) that there are usually no national investors with the relevant sector experience in the divesting country and that the search for a buyer with operating

¹⁸ Indeed, the law organizing such public bodies or the specific law governing the "public law SOE" to be divested would normally preclude an ownership transfer to the private sector. In these cases, the concerned law would need to be amended or abrogated to enable the divestiture of the SOE as a legal entity.

¹⁹ In addition to the legal categories outlined in this section, there are a large number of special situation SOEs on which this paper will not dwell, such as: (i) municipal enterprises, which could be organized under private or public law; (ii) party enterprises, which raise special problems in particular in one-party States where confusion between the party and the state is prevalent, including in their property; (iii) socialist cooperatives, which may be considered public or private; or (iv) armed forces enterprises, which often have a privileged and occult status. Many of the issues raised in this paper are relevant to the divestiture of such enterprises, however.

²⁰ Similar issues arise when divesting an enterprise with a de facto dominant market position. The economic impact of these alternatives should be assessed before determining which legal instruments need to be applied. See also section on regulation of monopolies in Chapter II.

experience will have to focus on foreign companies; (ii) that such foreign companies may be constrained by their own regulatory framework; and (iii) that there is little chance of finding an operator with experience in running a telephone company in more than one country (i.e. its own), and in a developing country context in particular. Some of these characteristics are fast changing, however, as a result of a recent worldwide trend in deregulation and privatization of telephone companies.

In many service activities, fixed assets are not of great importance, but staff, trademark and the license to exercise the activity may be. Divestiture of State-owned banks raises a whole range of specific legal issues, which are often settled by special legislation; special approvals will need to be sought from the national banking regulatory agency and, where foreign subsidiaries are involved, from foreign regulators as well. In the case of railways, one will have to consider whether to privatize through divestiture, concession or a combination of both, depending on whether the government wishes to operate the track infrastructure, or transfer the ownership of such infrastructure, or only the management and maintenance thereof, to the private sector. These are only illustrations of how the sector in which the SOE to be divested operates affects the divestiture techniques.

Size of Enterprise

Legal issues vary a great deal depending on whether you are divesting a small restaurant or grocery store, the national telephone company or a major cement plant, for example. Most East European countries have adopted a two-pronged approach to privatization, focussing on small privatizations before moving on to large privatizations. Czechoslovakia and other countries even passed different laws calling for different privatization techniques for each group.²¹

Defining an Approach

As part of the overall strategy, the critical path of reforms needed for successful implementation of the divestiture program should be outlined. The sequencing and prioritization of such reforms should be thought through from the beginning. They are intimately linked with the choice of privatization techniques. If the government wishes to sell SOEs as corporate entities, for example, prior corporatization of the SOE may be necessary. If a public flotation is envisaged, a reform of capital markets may be in order.²²

²¹ See Annex I for a list of divestiture laws.

²² Chapters II and III describe these and other reforms in greater detail.

CHAPTER II. THE MACRO-LEGAL FRAMEWORK FOR DIVESTITURE

The concept of a macro-legal framework for divestiture covers legislation, institutions and systems needed for the successful design and implementation of a divestiture program, and may be broken down into three main components. The first may be referred to as a properly functioning legal system and requires the guarantee of the rule of law; it is briefly discussed below. The second one, the main subject of this chapter, may be referred to as the legal framework for business activity (or business law). It governs the operations of private enterprises and provides some of the rules applicable to divestitures. The third component governs the way the public sector, the government in particular, operates, including in its divestiture mode; it is discussed in Chapter III. The critical legal inputs required for divestiture are thus part general principles of law, part business law (including mergers and acquisitions), and part public and administrative law. Focussing only on divestiture legislation per se would hence make sense only in countries with a properly functioning legal system and a legal environment conducive to business activity. It would not be the right approach in most developing countries.

Refocussing the Role of the State

Guarantee of the Rule of Law

It may be useful to remind the reader, in particular the non-legal reader, of some basic principles of most legal systems, which may be considered as fundamental components of a proper macro-legal environment for PSD, namely:

- publicity of the rule of law, which enables all concerned parties to have access to the laws they have to abide by;
- clarity and certainty of the legal framework, which allows such parties to understand which laws are applicable to their situation, and what their specific meaning is;
- predictability in the application of the rule of law, which reduces the risks linked to changing interpretation, implementation or enforcement of the laws;
- stability of the legal, political and policy frameworks, which provides investors assurances that the State or government will not unilaterally and unfavorably change the basic conditions underlying their investment decisions;
- fairness, possibility of legal recourse, and due process, which provides access to independent recourse and dispute settlement mechanisms;
- or, in summary, a State governed by the rule of law²³.

These are basic legal principles underlying relationships between private economic agents, as well as between such agents and the State or any part of the public sector.

²³ The French expression "état de droit" succinctly captions this concept.

A Market-friendly Legal Environment

A macro-legal environment conducive to private sector development (PSD) must clearly be in place for successful divestiture.²⁴ This means, for example, that, where it exists, discrimination against the private sector must be abolished²⁵. In many cases, new rules of the game will need to be established and implemented. Creating and maintaining this level playing field, which would allow private entrepreneurs to engage in economic activity without unfair competition or interference from State bodies, may require for many developing countries a fundamental redirection of the role of the State in their economy, shifting attention from production to regulation and stimulation²⁶. Such shift requires major adjustments at all levels, hence strong political commitment, which is essential, not only to push through a legislative reform package including divestiture, but also to ensure its effective implementation. Reforming the macro-legal environment implies not only new laws and regulations fostering private initiatives and activities, but also institutions and administrative personnel to support, implement and enforce such laws and regulations.

The legislation existing prior to the launch of the divestiture program should be assessed in order to determine whether it enables (and fosters) the divestiture process under consideration. Such assessment would indicate whether the implementation of the proposed divestiture program can be done within the existing legal framework, or whether it should be modified to allow or facilitate divestiture. Although, optimally, all the laws described in the next sections should be in effect to have a proper legal framework conducive to PSD and divestiture, in most developing countries one will have to focus on the core part of the legal framework that must be in place for the divestiture process to succeed. Another approach would lead to endless delays. This constraint should be acknowledged up front. What this core package of legislative reform should be, will depend on the specific situation of each country and divestiture program.

Identified shortcomings with respect to this idealized environment should first be prioritized. Only reforms critical to the success of the divestiture program should be undertaken, either through amendment of the concerned piece of legislation or through incorporation in the divestiture legislation of provisions amending the incriminated ones. Such amendments can be either of general application or only for the purpose of the divestitures to be undertaken pursuant to the law. Some countries, including many former socialist economies and countries such as Argentina and Peru²⁷, have opted for a "big

²⁴ For a general discussion of legal aspects of private sector development, the reader should refer to "The Role of Law in Private Sector Development: Implications for the Bank's PSD Action Program", Legal Department Discussion Paper, The World Bank, November 22, 1989, mimeo, 27 pages.

²⁵ See p. 15 below.

²⁶ In addition to the public sector's key and traditional roles of developing and maintaining the basic physical and social infrastructure (such as transport, education, health) needed for economic activity.

²⁷ Under the title "Peru opens up economy with deluge of laws", Sally Bowen writes in the Financial Times, of November 20, 1991 (p. 8): "A 10-day deluge of 126 laws, more than half of them intended to stimulate private investment, has brought about the most radical reorientation in the Peruvian state for more than 20 years. (...) State monopolies have been eliminated, private individuals and companies may now compete directly with the state in such varied areas as telecommunications, the generation and transmission of electricity, and the provision of postal and railway services. They may apply for concessions to administer state-owned hospitals, airports and even schools. There is what ministers call an 'aggressive plan to sell off public companies, which have drained the Peruvian exchequer of up to \$2.5bn annually.'" The article further quotes the new prime minister, Mr. Alfonso de los Heros, as saying referring to Peru's terrorism problem: "Much more important is an adequate legal framework. If these decrees survive, then investment, both national and foreign, will come."

bang" approach to economic reform, with privatization as one of the many ingredients in a comprehensive legislative reform package.

Property Law

Key Property Issues

Property laws are the cornerstone of any market economy and are normally protected by the country's constitution or constitutional tradition. Some constitutions²⁸ or legal systems, the communist ones in particular, do not recognize the right to private property. Where this is the case, amendments to the Constitution must be made to enable the whole divestiture process. This happened in recent years in East and Central European countries (1989-90), in the former Soviet Republics (1991-92), and in other countries abandoning marxist ideology, such as Angola and Guinea-Bissau.

Divestiture is nothing else than the transfer of property or ownership from one person to another. Property laws are thus of the utmost importance in this context²⁹. Property or ownership rights cover a bundle (or package) of legal rights over assets, including the right to use the concerned assets and to dispose of them through sale, donation, destruction or other means. Such rights may be limited by law, though not to the point where they would become meaningless. Hence, one cannot speak of full property rights where the owner may not dispose of his rights.

Successful privatization requires the ability to transfer free and clear property titles. In the preparation of a divestiture program, the legal analyst should investigate how ownership and property rights are defined in the country concerned; how private ownership rights are recognized and protected; what limits, if any, are placed on the transferability of such rights; how titling, registration and cadastre³⁰ mechanisms function (or do not); what enforcement mechanisms exist to protect one's rights, including how effective the court system is; what limitations may apply to foreign ownership of certain types of property, such as land; etc. Also to be investigated are the availability of proper mortgaging procedures or other collateral mechanisms, and related foreclosure systems.

When the property regime in a country is not clear and property rights are not adequately protected, or where acquisition of property by foreigners or other groups is subject to restrictions, the divestiture legislation should attempt to remove these barriers.

Prior Nationalizations

Nationalizations under various guises were common fare in Eastern Europe for about three decades following the second world war, and in the sixties and seventies in Africa and Latin America. The determination of the rights of the "previous" owners, whose property was confiscated, expropriated

²⁸ See first section of Chapter III for a discussion of key constitutional requirements affecting divestiture.

²⁹ This section addresses key legal aspects of private property, whereas issues surrounding public property are described in further detail in Chapter III.

³⁰ A cadastre is an official register establishing the boundaries, size and ownership of real estate (land, buildings, etc.).

or nationalized in earlier decades, would require detailed analysis. Was this process carried out legally³¹, do previous owners (or their heirs) still have legal rights on the assets to be divested? Were they properly compensated or indemnified³², or do they still have financial claims against the State? Are there different categories of previous owners, and have they been dealt with in the same way? In East Germany, for example, some were expropriated by the Nazis, others between 1945 and 1949 under the Soviet military government, others yet by the East German communist regime. Some of these expropriations were carried out pursuant to a law and others by administrative fiat. Appropriate compensation was given in some cases, though not in others. Statutes of limitation may apply. Depending on the specifics of each case, the expropriated owner (or his heirs) may or may not have legal rights.

Where one decides that such detailed analysis is called for and concludes that previous owners still have enforceable legal rights, one will have to balance these against the rights of other parties (such as good faith occupants or new owners) and against the costs of trying to reestablish the *status quo ante* (the situation prevailing before the expropriations). Such matters will often need to be clarified or settled by law.

Where expropriations took place illegally or without proper compensation, some countries have opted for restitution as the preferred compensation mechanism. This may work where the expropriation laws were of limited scope and were executed not too long ago. In most other situations, conflicting claims on the property are bound to exist that need to be resolved. Property records evidencing prior ownership and previous transfers may not have been kept; previous owners may be deceased and different heirs may claim the property; such property may have been developed, destroyed or even leased or resold to a good faith private buyer³³. Moreover, court systems rarely have the capacity to adjudicate the multitude of claims that restitution laws would give rise to. For all these and other reasons, broad restitution laws are often not effective.

If enacted, however, restitution laws should definitely include a deadline for filing claims. Past this deadline, undisputed property could be privatized with a free and clear title, and previous owners' rights would either lapse or be subject to monetary compensation³⁴. This would limit post-divestiture claims against the new owners, which have occurred in Czechoslovakia and other countries and are very detrimental to the success of the privatization program. Many countries, in particular those that went through large-scale nationalization programs, have established special commissions or bodies to examine

³¹ Although they should be, laws are not always fair. In some legal systems, unfair laws may also be illegal under some conditions. The term "legally" means in accordance with the country's laws, whether fair or not. Legality and fairness are two different concepts.

³² There is a significant body of literature on the meaning of "just compensation".

³³ As Vaclav Klaus, Minister of Finance of the CSFR, stated in a June 21, 1991 letter to a Czech emigre, "It is not possible to ask for the surrender of property from people who have acquired it from the State in good faith, i.e. not through illegal means".

³⁴ Such compensation is provided in the Bulgarian privatization law of April 1992, which gives previous owners two months from the date of publication of the decision to privatize an enterprise to file a restitution claim. Past this date, they can no longer ask for restitution, but only for compensation by the State.

claims on nationalized property by previous owners³⁵. This keeps the judiciary from being flooded and ensures a more consistent treatment of claims.

The German privatization law of 1990 initially emphasized restitution as the main form of redress for the previous owners whose property had been unjustly confiscated. This approach created major bottlenecks, however, as conflicting claims were filed on most properties, hence freezing the privatization process. The German parliament had to enact a "Law for the Removal of Obstacles to the Privatization of Businesses and for the Promotion of Investments"³⁶, *inter alia* to authorize the fast privatization, despite pending restitution claims, of property needed for investment or business purposes. "New investors able to preserve jobs or provide additional investment take precedence over prior owners."³⁷ Exceptional provisions allow the Treuhandanstalt for a temporary period (i.e. until end-1992) to sell disputed property, while giving the prior owners the right to demand compensation for their lost property from the Treuhand. This amendment was critical to the acceleration of the implementation of the German privatization program. As of April 1992, additional amendments to the restitution law were under consideration to further facilitate and accelerate new investments³⁸.

Compensation is in many instances not only more efficient but also more equitable than restitution. Indeed, all affected parties can be treated in the same way, irrespective of their former property's fate. By dissociating the property to be privatized and the claims that may exist thereon, compensation schemes allow the State to divest previously nationalized property unencumbered. Buyers receive a clear title and residual claims are lodged against the State (or one of its agencies), rather than the new owner. In Hungary³⁹ and other countries, lack of resources may prevent divesting governments

³⁵ See for example Ghana's decree of 1979 establishing a "Confiscated Assets (Recovery and Disposal) Committee. See also Horn (1992) at p. 26 on eastern Germany: "Successful restitutions, however, amount only to 5 per cent of all restitution claims [filed by] Spring 1992. More than one million of such claims have been filed, and the great majority has still to be channelled through a special bureaucracy, the offices on open questions of property."

³⁶ Law of March 22, 1991, inserting *inter alia* a new section 3a in the Law on Settlement of Open Property Issues of 1990.

³⁷ Birgit Breuel, President of the Treuhandanstalt, Speech delivered at the Washington Vista Hotel, November 14, 1991.

³⁸ See Horn (1992), p. 28.

³⁹ Under the Hungarian Compensation Law (Act XXV of 1991), owners who suffered property losses at the hand of the State after 1949 (i.e. under the communist regime) are to be compensated on the basis of a set formula, based on the size of land or buildings and, for enterprises, the number of employees. Total compensation is capped (about US\$ 60,000) and subject to gradually decreasing rates. Payment by the government is not in cash but in negotiable bonds (to be traded on the Budapest Stock Exchange), that can be used in payment for State property (including shares in companies) being privatized. Except for rented residential properties, where tenants have preemptive rights, previous owners have a first right of refusal on their old property when it is put up for sale by the State or another public body. In addition, part of the equity of newly transformed or privatized companies is allocated to a compensation fund. In an article titled "Hungary's Compensation Promise Proves Hollow for Many Claimants", Peter Maass writes in the Washington Post (October 26, 1991, p. A14) "The 'compensation bonds' are viewed skeptically because the government has not specified which companies or apartments they can be redeemed for. Many Hungarians concluded that they would be offered only the worst of the state's assets. And just getting the dubious bonds is difficult because the government is demanding stringent documentation for each claim. (...) Applicants must provide an array of documents that are difficult to obtain. Land deeds are essential, but many families lost them over the past four decades. Often the deeds were taken by the Communist authorities." Claims are to be assessed by regional compensation offices, whose decisions are subject to judicial review. See also for a discussion of major compensation-related litigation preceding the enactment of this law: "Hungary: The Constitutional Politics of Compensation", Soviet & East European Law, Columbia University, Vol.2, No.4, June 1991.

from compensating previous owners at fair value or in cash, which contributes to the low popularity of this system with dispossessed owners.⁴⁰

Future Expropriations

Depending on the political situation prevailing in the country, investors may require guarantees against re-nationalization before committing themselves financially. Acceptable legislation on the State's eminent domain rights (expropriation) is essential in this respect. Indeed, all countries do reserve their right to take property from their owners against just compensation, when necessary for the public good, e.g. for the construction of major infrastructure works (roads, ports, railways, airports) or schools. Such expropriation rights should be limited, however, and subject to judicial review. Good eminent domain legislation by itself does not guarantee that unfair or political expropriation will not take place, as such legislation may be suspended or amended and officials in charge may decide to ignore it. Uncertainty with regard to the use by government of expropriation legislation or to future changes in such legislation will enter in investors' risk calculation⁴¹.

Intellectual Property

Investment decisions, whether by foreigners or nationals, are conditioned by the existence and effective enforcement of intellectual property laws protecting the owners' property rights. The legal framework for intellectual property protection typically includes international agreements to which the country has adhered as well as national laws dealing with patents, trademarks, copyright (including software), trade secrets, know-how and licensing. Tax laws determine to what extent revenues from technology transfers (e.g. royalties) are taxed by the State. In addition, many countries also have specific laws (or sections of laws) dealing with protection of intellectual property in specified sectors of the economy (e.g. pharmaceuticals). In the context of specific transactions, investors will not only want to be reassured about the overall legal framework for intellectual property protection, but may also request additional protection that may not be consistent with the country's competition laws and resist attempts by the divesting State to force them to transfer specific technology or licenses to the privatized enterprise.

Protection of Competition

The protection of competition and, more generally, the creation and enforcement of a level playing field in the marketplace is one of the most complex functions of the State, involving a multitude of different areas of economic policy and law and requiring a high level of bureaucratic competence. Divestiture programs should be designed in a way that fosters competition and contributes to the establishment of a competitive economy, as illustrated below through some examples. To achieve this objective, pre-divestiture reforms and restructuring will often be required⁴².

⁴⁰ For further discussion of this topic, the reader should refer to "Legal Aspects of Reprivatization in Eastern Europe" by Zoe Kolovou, World Bank mimeo, January 30, 1992, 68 p.

⁴¹ Political or non-commercial risk insurance is available from MIGA, as well as bilateral and private insurance agencies.

⁴² See section on legislation on prior restructuring in Chapter III below.

Non-Discrimination against the Private Sector

Non-discrimination between the private and public sector is an essential part of competition policy, and of particular importance in the context of divestiture. The private sector should be allowed to compete on equal footing with the public sector. This implies, *inter alia*: (i) the removal of subsidies, including State guarantees on borrowings, at least to SOEs in competitive sectors (public finance and SOE legislation); (ii) harmonization or alignment of SOEs on the fiscal regime (tax laws) applicable to private enterprises; (iii) removal of barriers to private sector entry; and (iv) equal access to State contracts (public procurement regulations). The establishment and maintenance of such level playing field needs to be protected by law. In some countries, such as Brazil⁴³, this type of guarantee is even provided by the Constitution.

The elimination of preferential treatment for SOEs in public procurement is often a vital component of competition policy. Indeed, public procurement matters not only from a public finance (cost containment) and public ethics (fraud prevention) point of view. The State (and the public sector, in general, i.e. including municipalities, SOEs and other public entities) represent, in most countries, a large share of the potential market for goods and services. An investor in a newly privatized company will count on continued access to this market. A fair and open public procurement system, consistently applied, would be his best guarantee.

Price Liberalization

Free and autonomous price setting by firms is essential for the functioning of a competitive market economy. In addition, regulations may be needed to prevent or sanction abuses⁴⁴. Price liberalization legislation should precede privatization, in particular in countries with heavy government controls on prices (e.g. the East and Central European countries in 1990-91, India). Indeed, without the freedom to set prices, few investors would be interested in buying SOEs. Furthermore, if the SOE is sold (presumably at a low price, reflecting the effects of price controls on future profits), subsequent price liberalization might result in a windfall profit for the investor and accusations of selling the SOE below its value.

Anti-Trust Provisions

Laws preventing the establishment of cartels, trusts, monopolies and other restrictive business practices may need to be developed to deter anti-competitive behavior by firms and should be equally applicable to private enterprises and SOEs. One consequence of introducing such legislation may be that some divestiture transactions that would otherwise have gone ahead may need to be blocked on competition grounds. The acquisition of an SOE or other State assets by a competitor could indeed result

⁴³ Article 173 of the 1988 Constitution states that "The public corporations, mixed-economy firms, or other entities that engage in an economic activity are subject to the same distinctive legal regime as the private companies, including aspects relating to labor and tax obligations" (paragraph 1), and "public corporations and mixed-economy firms shall not enjoy fiscal privileges that are not extended to the private sector" (paragraph 2).

⁴⁴ See section on anti-trust below.

in an unhealthy concentration of market power.⁴⁵ The divestiture process should normally not lead to the mere conversion of public monopolies into private ones, nor to the formation of monopolistic or oligopolistic situations, where one or a few companies control the relevant market without any countervailing checks.⁴⁶

Irrespective of whether anti-trust laws are on the books or not, the divesting State should consider breaking up monopolistic SOEs prior to their divestiture⁴⁷. Indeed, this is often preferable to the set-up of an elaborate regime of regulation and fair trade practices, in particular in countries with weak administrative and judiciary capacity.⁴⁸ Finally, where anti-trust legislation does not exist or is not adequate, anti-trust provisions may also be included in divestiture tender documents and agreements.

Deregulation and Delicensing

Many developing countries are burdened by an unreasonably high level of government regulation of economic activity, that may have to be reduced in order to attract investors. The streamlining of licensing and other government regulations and permits required to conduct business should be a priority in such countries. If, for example, domestic content requirements prevent an investor from using inputs produced by his traditional suppliers (including companies under his control), he may not be interested in participating in a divestiture program. India abolished many of its industrial licensing requirements in 1991-92 as part of its liberalization program. Similarly, in the context of a broader economic reform program including privatization, President Menem of Argentina signed on October 31, 1991, a "decree closing dozens of government agencies and eliminating the often petty bureaucratic controls on private business activity. (...) [F]undamental barriers to economic efficiency, such as the 36 agencies involved in regulating foreign trade, would be abolished."⁴⁹

Regulation of Monopolies

Changes in the regulatory environment in which privatized companies will be operating may be required as a result or corollary of divestiture. This section focuses on the regulation of monopolies being divested as such, as is normally the case when "natural monopolies" are privatized.⁵⁰ In many

⁴⁵ See also section on foreign legislation below (p. 32).

⁴⁶ Where natural monopolies are divested as such, they will need to be regulated, as discussed below. The presence of trade protection also needs to be considered in evaluating monopolistic or oligopolistic situations (see p. 19 below).

⁴⁷ See section on prior restructuring below in Chapter III.

⁴⁸ In an article on "Enforcing anti-trust law in central Europe", Michael Reynolds writes that despite the recent enactment in Poland, Hungary and Czechoslovakia of competition laws modeled on the EC legislation, "newly-privatised enterprises will continue to operate in the context of a heavily-concentrated distribution system. It will take a long time to shake off bad habits acquired over some 40 years in a system where markets were shared with impunity, complete sectors were dominated by a single monopoly and enterprises traded on agreed prices fixed by government. (...) The fundamental question is: how effective will the enforcement of these laws be? Many countries have competition laws on the statute book which are often quietly ignored or enforced halfheartedly." Financial Times, September 26, 1991, p.14.

⁴⁹ "Menem Sweeps away Economic Regulations", Financial Times, November 1, 1991, p.8.

⁵⁰ See Bradburd, Ralph, Privatization of Natural Monopoly Public Enterprises (1992).

countries, public monopolies were not regulated prior to divestiture, precisely because they were public and somehow expected to pursue the public interest. In the context of their transfer to the private sector, opportunities and benefits from breaking up the existing monopoly must first be assessed. Some of their activities may now be opened up to private competition⁵¹, whereas others will remain monopolistic and thus in need of regulation.

Where a monopoly is transferred to private investors, the most valuable asset may not be the physical infrastructure, but rather the license or right to provide the monopoly service under specified conditions.⁵² Such license is normally given for a limited period of time and is usually revocable if the beneficiary fails to comply with the terms of the license. It always implies monitoring by the government or special regulatory body of the way in which the private monopolist fulfills its obligations, and normally includes mechanisms to modify rights and obligations under the license as circumstances change.

The degree to which the company will be regulated after divestiture is bound to have a direct impact on its valuation, as more stringent regulation or lower protection from competition invariably mean lower profits, hence lower share price. This is well illustrated by share price fluctuations following changes in the regulatory framework affecting the concerned company.⁵³

The proper sequencing of regulatory reform and divestiture is usually critical. In order to determine the price they are willing to pay, investors need to know under what regulatory regime the company will be operating. Where a public utility is being divested, for example, investors will not only want to know what the regulatory regime at the time of divestiture will be, but also how it is likely to evolve in the following years. An undertaking from the government not to substantially modify this regime, or at least not to the detriment of the company, would be desirable. To be effective, however, such undertaking must be credible or backed by some type of guarantee (e.g. a provision in the privatization agreements or license allowing the company to adjust its tariffs in order to neutralize the effect of a detrimental change in regime). Otherwise, the promise may not be taken seriously and bidders will submit lower offers.

The type of regulatory environment put into place may also have an impact on the choice of divestiture objectives and techniques. If a utility is regulated on the basis of a rate of return on invested capital, for example, trying to maximize divestiture proceeds (i.e. the sale price) may simply result in higher user rates, needed to reach the authorized (regulated) rate of return on invested capital⁵⁴. So, if the generation of revenues has been set as the priority for the divestiture (which should in general not

⁵¹ Such activities would normally be subject to the competition laws discussed in this chapter, although they may also be covered by the regulatory framework established for the remaining monopolistic activity, if both are conducted within the same company. Indeed, regulators will want to ensure that regulated activities do not cross-subsidize unregulated ones.

⁵² Two legally very different privatization techniques tend to be used for the privatization of monopolies. In the first case, the ownership of the SOE is transferred to the private party, together with the rights to operate the service. In the second, the SOE or its assets are leased to the private operator for the duration of his license.

⁵³ Shares in BAA (the British Airports Authority), for instance, rose by five per cent on November 18, 1991, "on the highest daily turnover since the day of flotation in 1987, as investors were encouraged by its improved prospects on the Civil Aviation Authority's new pricing formula for traffic charges". Financial Times, November 19, 1991, p. 22.

⁵⁴ This would not apply if the rate of return is based on the company's book value, which may greatly differ from the price paid.

be the case), another rate pricing formula, such as inflation minus 'x' points⁵⁵, may be more appropriate. The latter formula is also widely seen as providing operators greater incentives to reduce costs.

The telephone sector provides a rich base of experience in the area of divestiture⁵⁶ and regulation. As in other sectors, the UK experience in privatizing British Telecom has created an interesting and controversial precedent, which illustrates the difficulty of setting up a fully satisfactory regulatory framework.⁵⁷ This difficulty is compounded in developing countries, due to civil service pay scales, regulations and practices, political interference, weak judiciary systems, dearth of trained professionals, lack of experience in regulating private monopolies and other constraints.

In Venezuela, for example, the government submitted a telecommunications law to congress, creating a new regulatory framework and agency for the sector. As congress did not pass the law in time for the privatization of CANTV (the telecommunications company), the government passed a decree establishing a regulatory agency, which is primarily in charge of regulating and reviewing tariffs after an initial period stipulated in the concession agreement. The bulk of the regulatory framework was incorporated in the concession contract granting CANTV the right to operate the system. By and large, contractual regulation of this type may be preferable to unilateral regulation by a special body. One should be cautious not to curtail the powers of the legislator or regulator too much, however. Indeed, the protection of the public interest may sometimes require unilateral changes in the regulatory framework. A proper balance has to be found between the legitimate interests of the private operator and those of the public.

In deciding on the proper regulatory instruments, mechanisms and institutions, the accent should be placed on ensuring that the private provider of public (monopoly) services is operating under a good

⁵⁵ "RPI - X" is the term used in the UK, where RPI stands for Retail Price Index. In the case of British Telecom, the 'x' was initially set at 3% and subsequently raised to 4.5% and 6.25%. The 'x' factor "is likely to change every 4-5 years. These changes will at least in part be influenced by any difference between BT's actual rate of return and the cost of capital. The main difference between RPI-X regulation and rate-of-return regulation then is that the RPI-X formula allows for a longer regulatory lag." From "World Bank Conference on the Welfare Consequences of Selling Public Enterprises. Case Studies from Chile, Malaysia, Mexico and the U.K.", Chapter 4, Section IV.C.3, Washington, D.C., June 11-12, 1992.

⁵⁶ See, for example, "Privatizing Telecommunications Systems. Business Opportunities in Developing Countries", William W. Ambrose, Paul R. Hennemeyer and Jean-Paul Chapon, IFC Discussion Paper 10, Washington, D.C., 1990.

⁵⁷ "How much should regulators reveal about their plans for industries under their supervision?" asks The Economist. "Too little, and the regulated firms' managers, investors and competitors are obliged to make long-term decisions based on loose guesswork. Too much, and regulators find themselves prejudging issues they have had too little time to consider. In Britain these questions are politically sensitive right now, because the government is about to sell half its remaining 49% stake in BT, the near-monopoly telephone company. Potential investors know that what BT's regulator, OFTEL, decides over the next few years will affect its profitability much more than anything BT's management is likely to dream up. So they want to know more about OFTEL's intentions. (...) The silence is the result of conflicting interests. As seller and policy-maker, the government is pulled two ways. It wants to raise as much as it can for its shares, partly to curb its expanding borrowing requirement and partly to avoid accusations of a give-away. To do that, it needs to talk BT up. At the same time, it wants to be seen to be promoting competition in Britain's telecommunications industry, and to be equipping the regulator it created with the means to do its job. OFTEL itself is in a similar bind. Sir Bryan wants both to assert his independence from the government and to avoid controversy that might lose him his job when he comes up for reappointment next June. The same forces act upon any government, and any regulator, when state-owned industries go private." (from "The regulators' bind. When governments sell their stakes in industry, frankness is best", The Economist, November 2, 1991, p. 18.) In the end, OFTEL did make a statement prior to flotation. Slightly more than half of the State's shares in BT had already been sold to the public through a public offering in November 1984.

set of incentives, i.e. that the private company has built-in incentives to refrain from abusing its dominant or monopoly position. A credible threat by the government to establish a regulatory body with strong powers could be one such incentive. Under the right conditions, self-regulation may be more effective than the creation of regulatory watchdogs, in particular in small countries and countries with weak administrative capacity and judiciary systems. Indeed, regulation has a cost, which should not exceed its benefits.

Trade Legislation

Low or moderate external protection (tariffs, quotas, etc.) fosters import competition. In their negotiations with the State, however, investors often try to ensure that trade legislation is applied or modified to their advantage, which may conflict with the objective of an efficient and competitive economy. In this context, many investors have sought special protection from competing imports. If any exemption from the normal provisions of trade legislation is granted to a buyer, this should be done in a transparent fashion and factored into the evaluation of offers. An investor would clearly be willing to offer more for a company if it is protected from import competition, but this higher price has to be weighed against the cost to the economy of such added protection⁵⁸. Trade-related issues of interest to investors would further include regulations on tariffs, quotas, export subsidies, import and export controls, shipping documentation, as well as the country's adhesion to GATT as well as bilateral, regional or multilateral trade agreements.

Important Aspects of Business Legislation

General business legislation is highly relevant to divestiture. First, the applicability of ordinary corporate law to the divestiture transactions envisaged needs to be checked. In this context, liquidation, insolvency, bankruptcy, and capital markets legislation are particularly relevant. Second, some of the laws reviewed in this section may need to be amended, suspended or abrogated in order to enable or facilitate divestiture. Third, the nature and investor-friendliness of a country's business law is a determinant of investment, foreign as well as domestic. A sound legal framework for business activity is bound to facilitate the divestiture process and increase its chances for success.

Contract Law

Contract law and enforcement mechanisms for private contracts are a cornerstone of the legal framework for a market economy regulating the way in which property rights are transferred. Not surprisingly, the reference to the "sanctity of contracts" is a common one in modern legal systems. The subject is too broad to be discussed in the context of this paper. Suffice it to remind the reader that

⁵⁸ Guinea, Togo and other countries have granted very generous protection in the context of their privatization programs, including protection from import competition through high tariffs on competing products.

contract law is essential to PSD and to divestiture, which is always translated into some type of sale contract, and more often than not in a complex package of interlocked contracts.⁵⁹

Company Law

Company laws typically set the basic rules for the establishment, incorporation, management, operation and liquidation of companies. Many company laws are overly cumbersome, and may need to be amended to allow the expedient setting up of a company, through removal of red tape and delays in company incorporation and registration. Company laws authorize basic types of companies (with or without limited liability, share capital, etc.), grant them full legal personality, determine minimum capital requirements, determine the extent to which shareholders are liable for company debts, set rules regarding sale or transfer of shares, provide minimum guidelines in terms of corporate governance (including functions and powers of shareholders, boards, management and employees), etc. Company laws should grant companies the necessary latitude to opt for other schemes than those set forth in the standard provisions of the law and design their own corporate governance schemes, provided shareholders and creditors are adequately protected⁶⁰. Company laws or regulations may need to be drafted, amended or streamlined to adapt them to the requirements of the divestiture program.

In the case of the divestiture by the State of its holdings in a joint venture company with private shareholders, company law and company bylaws would often grant the other shareholders the right to approve any transfer of shares to non-shareholders or even a right of first refusal (preemptive rights). Where this is the case, the government may first wish to consult with the other shareholders to explore various alternatives for restructuring and/or divestiture. Alternatively, where the risk exists that minority shareholders could block the implementation of the divestitures, some divestiture laws have included a special derogation from normal company law⁶¹. Such provisions should normally be avoided, however, as they amount to a unilateral modification by the State of a commercial agreement it had entered into with other parties.

Attention should also be paid to rules pertaining to the creation, operation and sale of subsidiaries, affiliates and branches. This is important for a number of reasons, including (i) the proliferation in many countries of subsidiaries of SOEs, which are most often subject to ordinary company law⁶²; (ii) the existence in a large number of countries of State holding companies which are the legal owners of many SOEs; and (iii) the fact that many private buyers of SOEs are existing corporations that may want to organize the acquired company as a subsidiary. The Treuhandanstalt, for instance, has been embroiled

⁵⁹ Also, the availability of special business contracts, such as leasing or franchising, may be very important for the privatization of SOEs in some economic sectors, such as hotels, for example. In fact, they are in essence a non-divestiture form of privatization.

⁶⁰ Private investors entering into shareholders agreements with the State or public sector in the context of joint ventures in which the private investors hold less than 50% of the shares may demand the right to appoint the company's management team and a majority of board members, as well as other special provisions such as a higher quorum and special majorities for shareholders meetings. Such special schemes should be permissible under the company law.

⁶¹ See, for example, article 15 of the Senegalese privatization law of 1987, which provides that the provisions of the Civil Code requiring the prior approval of other shareholders before selling to non-shareholders do not apply to share transfers carried out pursuant to the privatization law.

⁶² This implies, *inter alia*, that the divestiture of these subsidiaries may be governed solely by ordinary company law and may thus be effected by decision of the competent organ of the SOE without governmental approval (see also p. 45 below).

in legal arguments regarding its responsibility for the debts of the companies it controls. These arguments have centered on German case law, which holds parent companies liable for the debts of subsidiaries in cases where the parent interferes in the business of its subsidiary or fails to keep the property of parent and subsidiary clearly separate⁶³.

Accounting and Auditing Legislation

The issues arising in the area of accounting and auditing legislation may be somewhat different in the general context of PSD and for divestiture in particular. In the first case, accounting and auditing procedures matter mainly for their direct impact on the company's tax obligations and for truthful reporting of the company's situation to its shareholders (minimum disclosure requirements would typically be specified). Also, a company's freedom to choose its own auditors should be protected. The requirement to have company accounts audited by a public body (such as a financial inspectorate at the Ministry of Finance) would not be considered acceptable by many investors.

For divestiture, potential buyers may not be overly concerned with the SOE's official accounts, but more with a precise status of its assets and liabilities. Investors would in any case perform their own due diligences⁶⁴. Where buyers are to take a large stake in the company, they will want to have the opportunity to carry out a thorough audit of the company's financial situation and would typically place little faith in the SOE's official accounts, either because of poor accounting regulations in the country, lack of familiarity with the accounting standards of the country (which may vary greatly from the ones they are used to), or poor records and accounting within the SOE.

In the case of a public flotation, however, individual investors would not have the opportunity or resources to personally investigate company operations, including accounts. Such investors need to rely on financial statements audited and certified by reputable and independent auditors. Furthermore, such audits should be a prerequisite for listing the company's shares on a stock exchange.

⁶³ See Horn (1992), p. 6.

⁶⁴ When buying a company or asset, buyers will normally engage in some due diligence to assess the economic prospects, assets and liabilities of the enterprise to be divested, including any hidden legal defects that may affect the company, some of its assets or their transferability. A typical due diligence evaluation for an SOE being divested would include: (1) an assessment of its corporate form along with a review of its by-laws, charter, minutes, etc. (2) an evaluation of the company's outstanding contracts (both purchase and supply agreements), of their enforceability and of the possibility to renegotiate them, (3) a review of the ownership status and transferability of assets, such as intellectual property rights, patents, trademarks, or real estate, (4) an assessment of any labor regulations or practices applicable to SOE employees, as well as the existence of any labor agreements or arrangements of special relevance to the divestiture process, (5) an evaluation of the company's outstanding warranties, and product liability risks, if any, (6) an assessment of "what governmental permits, approvals and licenses are necessary for the company to conduct business" along with their transferability to the purchaser under applicable laws, (7) an evaluation of the company's degree of compliance with applicable laws (i.e. competition, environmental, labor, etc.) and the ensuing risks of legal action, (8) a review of the company's observance of any applicable tax laws, as well as an assessment of the divested company's treatment under tax laws applicable to companies, and (9) an evaluation of any pending or expected litigation, and a re-evaluation of how the company, once divested, will handle these claims. See Chaudhri (1991).

Legally enforceable accounting rules following generally accepted international accounting principles should greatly improve the prospects for a successful divestiture program by creating greater transparency and certainty, hence reducing risk.⁶⁵

*Liquidation and Bankruptcy*⁶⁶

Liquidation and bankruptcy are critical exit mechanisms, which allow underperforming enterprises to be wound up, hence freeing resources up for more productive uses⁶⁷. They are also often used as divestiture mechanisms. Even though these two concepts overlap⁶⁸, they should be considered as distinct divestiture techniques.

The term "liquidation" applies to the winding up of an enterprise where, for whatever reason, the owners of the enterprise have decided to dispose of it by selling off its assets and business (often as a going concern), paying off its liabilities, and distributing the proceeds amongst themselves according to their respective share entitlements. In most countries, liquidation is regulated by provisions of the company law. Liquidation of an SOE refers to the process whereby the State disposes of the enterprise by transferring the ownership of enterprise assets (and liabilities), rather than of the enterprise itself. In a liquidation, the owner is usually responsible for any liability of the enterprise remaining after the end of the liquidation process and the dissolution of the enterprise. Liquidation often enables quick and efficient divestiture without the trappings and sophistication of bankruptcy. As such, it is a preferred divestiture technique in many developing countries, including Mexico in the first phase of its divestiture program and most Sub-Saharan African countries. Furthermore, liquidation tends to be the divestiture technique of choice for SOEs with poor accounts or unknown, uncertain or contingent liabilities.

Bankruptcy, on the other hand, is not a common divestiture technique, but has been used in this context in specific privatizations in Columbia⁶⁹, Mexico⁷⁰ and a number of other countries. Bankruptcy

⁶⁵ For a more detailed discussion of accounting issues in divestiture, see "Identification of accounting problems arising during privatization and their solution", Report of the Secretary-General, United Nations Economic and Social Council, E/C.10/AC.3/1992/5, 4 February 1992.

⁶⁶ The author wishes to thank Mr. Ronald Harmer for his comments on this section.

⁶⁷ In this context, investors may also want to know what would happen in case they decide to liquidate their company voluntarily: would they, for example, face any restrictions on the sale of assets or repatriation of sale proceeds? Restrictions of this type, which tend to be found in foreign investment or foreign currency regulations, act as a barrier to private sector investment.

⁶⁸ The term liquidation is also used to describe the stage of the bankruptcy process by which the assets of an insolvent company are sold and the proceeds distributed to its creditors according to an order of priority specified by law, and on a pro rata basis between creditors of equal rank where the proceeds are insufficient to meet the debts of those creditors.

⁶⁹ The assets of Papelcol, a major paper mill that was under "concordato" (an equivalent to the US Chapter 11 bankruptcy proceedings), had to be taken out of bankruptcy court by its owner and (eventually) main creditor, a State holding company, before they could be divested to a private company. See Quale, pp.6 and 16.

⁷⁰ Aeromexico was placed in bankruptcy in April 1988. In September 1988, Aerovias was created as a new company with the bankruptcy trustee and the pilots' union as shareholders and with a capital of about US\$44,000. The company took over the operations of the airline and reached new contract agreements with the main unions representing a drastically reduced work force. During the same month, the trustee offered Aeromexico's assets for sale. The winning bidder offered to buy most assets, with the exception of aircraft, engines and unneeded spare parts, as well as 75% of Aerovias, leaving the other shares to the pilot's union. The offer also included leasing the needed aircraft. The offer was accepted and the sale contract signed in November 1988.

differs from liquidation in several ways. First, the bankruptcy process is managed or supervised by the courts, usually with the assistance of court-appointed trustees or administrators. Second, bankruptcy typically implies that the company is insolvent: company managers may be required by law to file for bankruptcy if the company becomes insolvent or unable to meet its financial obligations; failure to file may be subject to penalties. Third, the process may be initiated by the creditors or the courts (or public prosecutor), even against the owner's objections. The use of bankruptcy procedures as a divestiture technique requires a well-functioning court system, a condition that is not met in many developing countries, where weak or inefficient judicial institutions tend to be a major bottleneck for the implementation and enforcement of this critical market exit mechanism. Protracted litigation is not uncommon in this area, and courts are often not adequately equipped to fulfill their mandate. Also, many countries do not have a cadre of well-trained bankruptcy administrators (trustees) who can be entrusted by the courts with the management of companies under bankruptcy proceedings. Finally, as the enterprise's creditors tend to be key actors in bankruptcy proceedings, the choice of this mechanism as divestiture technique may render the pursuit of objectives other than revenue maximization more difficult.⁷¹

One should check whether commercial liquidation, bankruptcy and insolvency laws apply to SOEs or not⁷². Where such laws do apply, one would have to ascertain whether the existing legal provisions are adequate to deal with the expected SOE liquidations, especially with respect to the protection of SOE creditors. The State may need to waive some of its claims on the SOE (e.g. SOE arrears on tax liabilities) to the benefit of the SOE's private creditors, in particular its secured creditors. In addition, the State may still be liable for unsatisfied claims against the former SOE, including claims filed after its dissolution.

SOEs should to the extent possible be subject to the same liquidation and bankruptcy laws, regulations and practices as private enterprises. Weaker rules or a differentiated application of the same rules⁷³ may indeed allow sick SOEs to compete unfairly against other enterprises. The sudden application of commercial bankruptcy legislation to the SOE sector as a whole, however, if not preceded by in-depth financial restructuring of the concerned SOEs (in particular those with a negative net worth), might result in massive bankruptcies, threatening the survival of the government and its reform program. This could be the indirect consequence of a broad corporatization program, which would subject SOEs not only to private company law, but also to other business laws, such as bankruptcy laws, a fact often overlooked by proponents of across-the-board corporatization. In-depth SOE restructuring may thus be required before subjecting such SOEs to commercial bankruptcy laws.

Adapted from "World Bank Conference on the Welfare Consequences of Selling Public Enterprises. Case Studies from Chile, Malaysia, Mexico and the U.K.", Chapter 17, Washington, D.C., June 11-12, 1992.

⁷¹ It should also be noted that effective bankruptcy laws can represent a threat (or incentive to perform) for managers, though only after the company's fortunes have declined so much as to bring the company to the brink of bankruptcy.

⁷² In the latter case, a special SOE liquidation law may exist. See section on SOE liquidation legislation in Chapter III.

⁷³ Creditors, and in particular State-owned or controlled banks, may be reluctant to initiate bankruptcy proceedings against SOEs. Similarly, SOE managers and board members often have no incentive to initiate liquidation procedures, even when they are required to do so by law. In many countries, failure to comply with the law is unlikely to be sanctioned, whereas initiating liquidation of the SOE will most likely cost them their job.

Transfer of Liabilities

Most legal systems have specific rules regarding transfer of debts and obligations (including contingent liabilities, such as those resulting from on-going or potential litigation). In civil law countries, a transfer of liability would be subject to the creditors' approval⁷⁴. Without such approval, the original debtor would remain liable.

If a divestiture is carried out through sale of the original SOE (i.e. the legal entity that was the original debtor), whether as a corporate entity or through sale of shares, the privatized company remains the debtor. In some countries, such as Bulgaria, commercial law requires that the seller of a company (i.e. the State in case of SOE divestiture) give prior notification to the company's creditors of the impending sale; unless creditors agree otherwise, the seller may remain liable, even after the sale, for pre-divestiture company liabilities.⁷⁵

If, on the other hand, the SOE's legal status changes⁷⁶, as would be the case as a result of corporatization, creditors might not be satisfied with their new status. Indeed, the transformation of the original debtor from (typically) an unlimited liability public corporation implicitly backed by the credit of the State to a limited liability company organized under company law may reduce the comfort or security afforded to its creditors to the amount of the new company's stated capital. Corporatization provisions of laws in Sri Lanka, Poland and other countries stipulate expressly that the old SOE's liabilities are taken over by the new company.⁷⁷

As, in many instances, SOEs would not be attractive take-over targets with their existing debts and liabilities, many governments have released them from such obligations either at the stage of prior corporatization of the SOE⁷⁸, or of negotiation of the divestiture transaction with the interested bidders⁷⁹.

Similarly, if the original obligation of the SOE was guaranteed by the State (e.g. a World Bank loan), such guarantee would remain, even though the post-divestiture owner is a private party. Again, in many legal systems, the State could not transfer its guarantee obligation to a third party without the

⁷⁴ See, for example, the rules applicable to transfer of debts (in French: "novation de débiteur") under Napoleonic civil codes.

⁷⁵ See article 15 of the Bulgarian Commercial Code of May 16, 1991.

⁷⁶ See pp. 6-7 above.

⁷⁷ The Sri Lankan law allows the transformation of SOEs into joint stock companies by administrative action and stipulates that the liabilities of the enterprise are deemed to be liabilities of the new corporation. Similarly, article 8.2 of the Polish privatization law of July 13, 1990, provides that "the company formed as a result of the conversion of a state enterprise assumes all the rights and liabilities of the converted enterprise". See also New Zealand's SOE Act of 1986.

⁷⁸ See, for example, Section 62 of the British Telecommunications Act 1984.

⁷⁹ In a November 14, 1991 speech to American investors in Washington, D.C., Ms. Birgit Breuel, President of the Treuhandanstalt declared: "With respect to existing debt and environmental liabilities [of SOEs being divested], we will also negotiate flexibly. The extent of our generosity will depend on the attractiveness of your proposal." "In and of itself, the purchase price will not be the sole decisive factor. The amount of planned investment and the number of guaranteed jobs is also important to us." "Since its inception [in the Fall of 1990], the Treuhand has on average assumed 85% of the existing debt of businesses which have been privatized." The Treuhand's authority to assume SOE debts incurred prior to July 1, 1990, derives from the Debt Relief Decree of September 1990. See also section on prior restructuring in Chapter III.

approval of the concerned creditor⁸⁰. If the divestiture consists of the transfer of a package of assets and liabilities, rather than the transfer of a company (or shares therein), the issue would need to be explored in greater detail.

Environmental Legislation

Potential liability for environmental damage caused by the former SOEs was one of the main reasons for the slow start of the German privatization program. The legislation had to be amended to allow regional governments to release investors from environmental liability arising out of the SOE's pre-divestiture activities⁸¹, and the Treuhand had to absorb the bulk of the cost of such environmental damage and related liabilities⁸².

In general, interested buyers need to know the extent of their liability for environmental damage or violations of environmental legislation due to the former SOE⁸³. If liable, they may want to negotiate a ceiling of liability above which they would be compensated by the State. If the new owners are not liable, will the State assume responsibility? If SOE facilities do not conform to environmental regulations, will exemptions be granted or will the buyer be given a certain time period to comply? Who bears the cleaning up costs incurred in bringing a factory or land up to environmental standards? All these are questions that may find an answer in the country's environmental or privatization laws, or upon which the parties to a divestiture transaction may agree in their contractual documents. Also, potential buyers will be interested in new environmental regulations that could affect their future obligations.

Foreign Investment Laws

Some aspects of the foreign investment regime affect all foreign investments, whereas others have a larger incidence on divestitures. One would need to check *inter alia* whether: (i) the country's

⁸⁰ In the divestiture of VASP, the Brazilian airline, this problem was averted by demanding that VASP's creditors be paid by the purchaser, and that the purchaser issue a counter-guarantee backed by hard assets to reimburse the government in case its guarantee were ever called.

⁸¹ "A strict application of West German environmental laws would have resulted in the shutdown of a major portion of East German industry. The 'Environmental Framework Act'... provides that purchasers of industrial plants or other commercial real property in eastern Germany may be released from liability for environmental damages caused by the operation of the plant or use of the property before July 1, 1990. Applications for such releases must be filed before March 29, 1992. A release will be granted if it is justified in light of the interest of the investor as balanced against the public interest in environmental protection. The [March 1991] Privatization Amendments now provide for the release of civil law claims of private parties as well as public law claims of the government. Previously, liabilities for civil law claims could not be released in this manner. (...) In addition to liability releases, which are issuable only after approval by the relevant German state, investors can obtain indemnification from the Treuhandanstalt with respect to past environmental liabilities." From "New Perspectives on Investments in Eastern Germany", Jones Day, Comments to Clients, May 17, 1991, pp. 1-2.

⁸² "The Treuhand is prepared to assume a substantial portion of the costs arising from environmental damage existing at the time of purchase. While the percentage cost assumed is subject to negotiation, the Treuhand in the past has assumed up to 90% of the related costs." Birgit Breuel, President of the Treuhandanstalt, Speech delivered at the Washington Vista Hotel, November 14, 1991.

⁸³ In particular in polluting industries such as the chemical, mining or steel industries.

constitution and laws adequately protect foreign investors⁸⁴; (ii) the foreign investment regime in effect discriminates against foreign investors, by restricting their participation in local companies to a given ceiling (e.g. less than 50% of equity), ruling foreign ownership of land out⁸⁵, or prohibiting or otherwise limiting their involvement in some of the sectors slated for divestiture; (iii) the foreign investment regime unduly discriminates against domestic investors, by granting foreigners tax and customs exemptions not available to domestic investors; (iv) rules applicable to foreign investors are clearly stated, or ambiguous and subject to broad administrative discretion⁸⁶; (v) regulations governing the relations between a parent company and its local subsidiary might deter foreigners from participating in the divestiture process; (vi) the benefits of the investment code (or similar legislation) apply to divestiture transactions, by which ownership of existing assets is transferred, or only to new "greenfield"-type investments involving the creation of new productive assets; and, finally (vii) the foreign investment and divestiture laws of a country go in the same direction or at cross-purposes.

Capital Markets and Securities Legislation

Although established capital markets greatly facilitate divestiture, they are not essential for the success of a divestiture program. Where such capital markets exist, divestiture may contribute to their further development. To the extent the program includes share flotations to the public at large (or at least to large numbers of investors), buyers should be able to trade shares on a secondary market⁸⁷, and this market will need to be regulated to protect investors.

In the absence of structured capital markets, divestiture options may be narrower. The lead time required to set up such markets is normally too long to be able to create them and start operations in time to use them as a major vehicle for divestiture transactions. A first step would be to develop basic securities legislation regulating the issuance and trade of shares, including the operations of financial intermediaries (banks, brokers, underwriters, etc.).

The government may also wish to foster the development of large institutional investors, who could participate as buyers in the divestiture program. This motivated the Chilean government to amend the law governing pension funds in 1985 to allow them to invest in company shares. The pension funds,

⁸⁴ In Brazil, article 5 of the 1988 Constitution guarantees a broad range of social, economic and political rights, including private property rights and the right to fair and prior compensation in case of expropriation by the State, but only to Brazilians and aliens resident in Brazil. Non-resident foreigners are not protected. Article 172 of the same constitution stipulates that "the law shall regulate investments of foreign capital, encourage reinvestment, and regulate the remittance of profits, all on the basis of the national interest". These constitutional provisions and other discrimination against foreigners in the divestiture law and regulations became a problem in the implementation of the government's divestiture program, resulting in limited foreign participation and lower sale receipts. Provisions like article 10 of Angola's 1975 constitution are not particularly reassuring either for foreign investors. It states: "The People's Republic of Angola shall recognize, protect and guarantee private activities and property, even those of foreigners, as long as they are useful to the country's economy and to the interests of the Angolan people."

⁸⁵ E.g. article 22 of Bulgaria's 1991 constitution.

⁸⁶ The Financial Times reports in an article on Hungary that "government publication of a list of strategic companies in which foreign control would not be permitted may paradoxically have had a beneficial effect. Clarifying the rules has made officials less hesitant." (10/30/91, Section on Hungary, p. VII)

⁸⁷ A secondary market does not necessarily mean an organized stock exchange in the traditional sense (i.e. with trading floor, etc.), however. All that is required for a secondary market to exist is a legal system which allows private parties to transfer shares freely to one another and to obtain registration or recognition of the transfer by the company concerned.

which were privatized in May 1981, became "by far the most important institutional purchasers of shares of state-owned companies being privatized" in Chile between 1985 and 1989⁸⁸. Similarly, the regulations governing the use of funds in Singapore's Central Provident Fund (equivalent to a pension fund) were changed in 1986 to allow withdrawals "for the purchase of listed securities approved by the CPF Board"⁸⁹.

Also useful in the context of divestiture is the option to "unbundle" the rights on SOE shares, for example by separating the right to dividends and other income from control and voting rights. This may or may not be allowed under prevailing company or securities laws. In some countries, such as Mexico and Jamaica, different categories of shares have been issued with different rights; part of the remaining government holdings in partially divested companies were stripped of voting rights, while those shares continued to be held by the government. This is particularly useful in cases where, due to the limited market capacity, a company is floated in a few tranches with the government remaining a majority shareholder in a first stage. In other cases, investors may find that a remaining State stake in the company provides additional comfort by reducing the risk of adverse State action towards the privatized company. Suspension or stripping of part of the government's voting rights results in private shareholder control over the company, a reassuring feature for many investors⁹⁰. On the opposite side and less reassuring to private investors is the "golden share", another derogation from ordinary securities legislation⁹¹.

Commercial Banking Laws

A properly functioning autonomous commercial banking system is critical to private sector development. Effective banking systems are needed to allow domestic investors to leverage their purchases and to enable local and foreign investors to finance future working capital requirements domestically. In addition, a broad range of financial sector laws, including sureties (collateral), credit, leasing and insurance, may also affect the success of the divestiture program.

Banking laws may need to be changed to authorize the divestiture of commercial banks, as was the case in Hungary, where parliament passed a banking act in November 1991, enabling divestiture of State-owned banks, while limiting any one shareholder, the State included, to a 23 per cent stake.⁹²

Banking law reform may also be needed to facilitate the divestiture of non-financial SOEs. In some countries, such as Senegal, where no formal securities markets existed, commercial banks were appointed as financial intermediaries for the flotation of shares. Finally, it may be needed to wean SOEs

⁸⁸ See "Privatization in Latin America. A LatinFinance Supplement", March 1992, p. 62.

⁸⁹ See "Challenges of Privatisation and Corporatisation. The Singapore Experience. Its Legal Aspects", Arfat Selvam, Rodyk & Davidson, Singapore, August 1990, p. 11.

⁹⁰ See Enrico C. Perotti, Transfer of Ownership and Control in Large Privatization Plans: Theory and Evidence from 10 Countries, mimeo (preliminary version), September 1991, Boston University. Writing about employee shares, Perotti further argues that "there may be an argument for limiting the voting rights of these shares as well, or perhaps suspending them during the early phase of restructuring, when opposition to necessary restructuring may be most damaging" (p. 11).

⁹¹ See pp. 56-58 below.

⁹² Financial Times, November 15, 1991, p. 3.

from easy credit obtained from State controlled banks or with State guarantees by forcing commercial banks to bear the risks associated with lending to SOEs. By reducing the SOEs' potential for incurring additional indebtedness, banking reform may thus further facilitate their divestiture.

Labor Legislation

Labor laws applicable to SOE personnel may be of particular concern in planning divestitures. If laying off workers is difficult under existing laws, potential investors may insist that redundancies be carried out by the State or the SOE prior to the divestiture⁹³. Rights of laid off workers, including severance pay and unemployment benefits, may differ depending on whether they worked in the public or private sector (or, to put it differently, on whether they were fired by the SOE or by the new private company). Where the legal regime for union representation is different in SOEs and private companies, transitional arrangements may need to be negotiated with the concerned unions. The post-divestiture situation of SOE employees who contributed to public sector pension and insurance plans will need to be determined. Similarly, their other contractual (or statutory) employment rights will need to be confirmed or modified, including salaries, seniority rights and other benefits. The legal principle at stake in many of these instances is whether there is continuity of the employment relationship or not.

Trade-offs may have to be made between the protection afforded incumbent workers by labor laws and the need to generate new employment opportunities. In Germany, for example, where normal labor laws restrict the admissible causes for lay-offs, parliament granted buyers of privatized enterprises a temporary exemption from these restrictions in order to facilitate the country's privatization program.⁹⁴ On the other hand, the Treuhand included in many privatization contracts a binding undertaking whereby the buyer guarantees a specified level of employment in the privatized firm, subject to contractually determined penalties for failure to comply with such undertakings⁹⁵. This negotiated approach is by far better than the legislated approach to employment protection chosen by some other countries, such as Sri Lanka and Pakistan, where new owners were prohibited from firing workers for one or two years following divestiture. This uniform requirement makes the whole privatization process unnecessarily rigid and difficult.

Where the SOE is not divested as a going concern and the buyers are taking over limited assets and obligations from the SOE, contracts with some workers may be part of the package. Under prevailing labor legislation, these workers may be entitled to severance pay from the SOE even though they are immediately rehired by the new company. This double-dipping may be prevented by special provisions to be included in the law or contractual arrangements with the workers concerned.⁹⁶

⁹³ See section on prior restructuring below.

⁹⁴ A March 1991 law provides a temporary exemption to "Section 613(a) of the German Civil Code, which provides that the purchaser of assets constituting a business assumes, by operation of law, the employment rights and obligations existing at the time of the purchase. A change in control through an acquisition of a business does not constitute 'cause' for the dismissal of employees. (...) The above-mentioned exemption provides that through December 31, 1992, Section 603(a) will not apply in the case of acquisitions of insolvent eastern German businesses." See "New Perspectives on Investments in Eastern Germany", Jones Day, Comments to Clients, May 17, 1991, p. 3.

⁹⁵ See Horn (1992), p. 19.

⁹⁶ In many instances, non-selected workers are left behind in a SOE shell with no remaining activity. Their contractual rights would be dealt with as part of the liquidation of the SOE.

Laws applicable to private labor will be of even greater concern in the context of divestiture, as they may affect the investor's ability to set wages and benefits, hire and fire workers, and in general manage his work force. In Brazil, for example, "ports are still governed by 1937 legislation which protects labour and results in costs which are among the highest worldwide". Mr. Modiano, the president of BNDES (the agency in charge of coordinating the Brazilian privatization program) declared that "we first need to modernise the legislation or no one will buy"⁹⁷. Work permits may be needed and restrictions may be imposed on the recruitment of foreign workers. The extent of labor rights in the management of the company, including union rights and employee entitlement to representation on the company's board and other management bodies, is another important issue.

Finally, some countries have reserved a tranche of shares in SOEs to be divested on preferential terms to their employees⁹⁸. This may deter some investors, who may not want employee shareholding in their company or simply want full ownership. Again, the constraint can be partly circumvented, for example through preferential employees shares without voting rights⁹⁹.

Taxation

Issues of particular concern to investors and potential buyers are the overall fiscal pressure on enterprises and the predictability of tax administration and enforcement. Businesses should be able to determine what the applicable taxes are and estimate the amount of taxes that will be due. Technical aspects may also be important, such as: (i) rules governing transfer pricing between enterprises of a group, in particular in relations between the local company and its foreign parent or sister companies; (ii) rules on tax loss carry forward, which may have a major incidence on the chosen divestiture technique¹⁰⁰; (iii) the tax treatment of ESOPs, leasing, franchising or other privatization mechanisms, which will often be the decisive factor pleading for or against such techniques; and (iv) double taxation rules.

Also, tax laws should be applied uniformly to private as well as public enterprises. Any tax benefits granted to SOEs in the competitive sector of the economy should be removed. Finally, some governments have granted special tax benefits to divestiture transactions, either pursuant to the country's investment code or to special provisions in the privatization law.¹⁰¹

⁹⁷ Financial Times, January 21, 1992, p. 24.

⁹⁸ See pp. 50-52 below.

⁹⁹ See articles 22.6 and 23.2 of the Bulgarian privatization law.

¹⁰⁰ If new owners can prevail themselves of such carryforwards, a loss-making SOE may be quite attractive. From the government's point of view, however, the higher sale price is offset by lower tax revenues in later years.

¹⁰¹ Such benefits range from exemptions of stamp and registration taxes related to the transfer of shares in the context of the privatization law (e.g. article 15 of the French privatization law of August 1986) to a temporary exemption from corporate profit taxes (e.g. article 30 of Tunisian law, which also provides for another half dozen tax exemptions). See also above section on foreign investment laws.

Currency and Foreign Exchange

The currency and foreign exchange regime will affect the divestiture process, in particular when the selling government wants to attract foreign investors. By and large, restrictions on allocation, availability, convertibility, repatriation, registration, or other uses of foreign exchange will hamper efforts to attract foreign investors. In countries without stable convertible currency, restrictions on domestic payment in foreign exchange, in particular payment of expatriate staff, domestic suppliers and payments by clients, would be of some concern too.

In the specific context of divestiture, some governments have considered establishing a special, less favorable, exchange rate for foreign investors bidding for State enterprises or assets as a way to compensate for what was perceived as an artificially depressed exchange rate, which would allow foreign bidders to buy significantly below value. Such schemes are not advisable, as they tend to be easy to circumvent and are difficult to administer. This also holds for multiple exchange rates, as in Russia, where the rate applicable to foreign investments is about ten times higher than the prevailing market rate.¹⁰²

Dispute Settlement

Litigation can be very costly and time-consuming. The functioning (or not) of a country's court system is an essential, though often overlooked, part of any legal framework for business activity. Potential investors will be interested in the competence and independence of the court system, in its accessibility and efficiency, as well as in the possibility to settle out-of-court. Indeed, conflicts arising out of contracts with local labor, banks, suppliers and clients will typically be submitted to the jurisdiction of the local courts.

Of equal importance is arbitration, which can be either domestic or international. Domestic arbitrations are typically conducted under local laws with the involvement of local arbitration institutions. International arbitrations, on the other hand, are typically conducted in accordance with sets of arbitration rules widely used in international business and often under the auspices of agencies specifically set up for the purpose of handling international caseloads¹⁰³. Domestic arbitration will be particularly important in countries with weak judicial systems, as an alternative for the adjudication of disputes involving smaller amounts and local parties (suppliers, clients, employees, etc.), whereas international arbitration is often the preferred mechanism for larger contracts, in particular with States¹⁰⁴. Enforceability of awards is of course also of major concern to potential investors.

The government's track record in dealing with investors and settling disputes as they arise is also critical. In Peru, for example, "the government admits (...) that settlement of three outstanding disputes with transnational companies already operating in Peru - Southern Peru Copper Corporation, Occidental

¹⁰² If on the other hand, the objective is to favor domestic over foreign investors, the same outcome can also be achieved through the attribution of a margin of preference to domestic bidders.

¹⁰³ Such as the arbitration mechanism set up by the International Chamber of Commerce (ICC) in Paris, and the International Center for Settlement of Investment Disputes (ICSID) in Washington, D.C.

¹⁰⁴ In this context, it should be noted that some States are barred by their laws from entering into arbitral settlements (e.g. Belgium until recently).

Petroleum and Belco - will be a prerequisite for attracting fresh short-term foreign investment from abroad."¹⁰⁵

To date, there has been very little international privatization-related litigation between divesting states and buyers, whether in courts or arbitration fora. Disputes have arisen in the courts of a number of divesting countries, including Turkey¹⁰⁶, Brazil¹⁰⁷ and some East European countries, though mainly during the preparatory phase preceding the conclusion of the related transactions.

International Law

In addition to a review of domestic laws and regulations, a proper diagnostic survey of business law applicable in a given country will also include an investigation of the relevant treaties and international agreements the country has adhered to¹⁰⁸. International treaties have been negotiated and have entered into force that deal with many of the areas of law outlined above. On all continents, countries have entered into regional agreements dealing with trade, customs or broader economic integration (e.g. EEC, Mercosul, CARICOM, NAFTA, ASEAN, UDEAC). Many of these regional agreements are the source of supranational law or foster the harmonization of laws in their member countries. Bilateral agreements (such as double taxation or investment treaties) should also be reviewed. An interesting, though highly unusual, case is that of the German Unification Treaty of 1990 which in its article 25 incorporates, with some amendments, the East German privatization law into German law.

Foreign Legislation

Foreign laws may potentially also be of high importance for the privatization process. In the ENTEL privatization in Argentina, for example, the initial tender documents required that the operator of the privatized telephone companies own at least 10% of the capital. Meanwhile, the Argentine government had expressed a clear preference to have one of the US telephone companies as operator. Under US law, however, the Baby Bell companies would not have been allowed to own more than 4.9%. Clearly, these two requirements were mutually exclusive, and the Argentine government decided to decrease the minimum level of operator-owned equity to 4.9%. This type of problem is normally identified and addressed at the due diligence stage (i.e. prior to the launch of the privatization transaction).

¹⁰⁵ Financial Times, November 20, 1991, p. 8.

¹⁰⁶ See Kjellström (1990), pp. 30-32. The transfer in 1989 of five state-owned cement companies to Société des Ciments Français and of a majority stake in the aircraft catering company USAS to an affiliate of Scandinavia's SAS was blocked by an administrative court in January 1990 on the basis of a suit filed by opposition parties against the decision of the government agency in charge of divestiture. In a March 1990 ruling, the court declared both divestiture agreements null and void on the grounds that they contravened the terms of a 1987 decree on privatization which gave priority to domestic buyers. In July 1990 "the Council of State rejected the appeal of the Government, thereby irreversibly canceling the sales of the cement plants and USAS".

¹⁰⁷ About thirty law suits were filed in attempts to block the Brazilian privatization program and in particular the privatization of Usiminas, the first SOE to be sold under this program. See Financial Times, January 21, 1992, p. 24.

¹⁰⁸ Different books provide an overview of such treaties. "Accords économiques internationaux. Répertoire des accords et des institutions." (Bernard Colas editor, Notes et Etudes documentaires, La Documentation française, Wilson & Lafleur, Paris, 1990, 483 p.) is a useful guide to international economic agreements and includes lists of countries party to the agreements reviewed.

Similarly, in the case of privatization of a bank that has foreign subsidiaries, the government should initiate contacts with foreign regulators, who may have to approve the effect of the ownership change on these subsidiaries. On a more general level, privatizations can raise international anti-trust issues, even where the privatized company would not be in breach of competition laws in the privatizing country.

In cases of large privatizations which require tapping the international financial markets, securities in the enterprise to be privatized may be issued in foreign capital markets, either simultaneously with the domestic offering or after the domestic offering. The securities regulations of such countries will need to be observed.¹⁰⁹

Concluding Observations

This chapter has attempted to illustrate how different parts of a country's legal framework that are usually not directly associated with privatization may have a far-reaching impact on this process. Respect for the rule of law, recognition and protection of private property, creation and enforcement of a level playing field in the market, and a broad range of other business-related legislation, as well as stability in the legal regime applicable to private sector activity, all have an impact on divestiture. Lawyers advising governments on privatization must determine which laws or legal institutions create the most severe bottlenecks for successful privatization in the concerned country. These will differ from country to country and will depend on the specific privatization programs. Once identified, the removal of these bottlenecks should become priorities in a larger legislative reform package fostering privatization.¹¹⁰

¹⁰⁹ Many UK privatizations were accompanied by private or public placements in the US through sponsored American Depositary Receipts (ADR) programs. The same occurred in the privatization of numerous companies, including many telephone companies, in Argentina, Chile, Hong Kong, New Zealand, Mexico and Venezuela. See "American Depositary Receipts and Privatizations", The Bank of New York, 1991.

¹¹⁰ Privatization would typically be only one of the elements of such reform package, which would include other reforms needed to increase the competitiveness and efficiency of the economy.

CHAPTER III. ELEMENTS OF DIVESTITURE LEGISLATION

The country's constitution, its public and administrative law may need to be changed to enable or facilitate divestiture. The first section of this chapter discusses key constitutional requirements with respect to divestiture. It should be pointed out, however, that most constitutions also deal with some of the legal issues discussed in the other sections of this chapter and in Chapters I and II. The following three sections address general areas of public law that may contain provisions applicable to divestiture per se. The core contents of a typical divestiture law are then outlined.

Constitutional Requirements

A first, mandatory step in evaluating the legal requirements for divestiture is the country's constitution or fundamental law, where such document exists.¹¹¹ In many socialist countries, all productive assets (including enterprises) were State or "all-people" property by virtue of the constitution¹¹², and the State (or public) sector received special protection and privileges¹¹³. In Portugal, the 1976 constitution stipulated the irreversible nature of the nationalizations that followed the April 1974 revolution, and had to be amended twice (in 1982 and 1989) to authorize the full divestiture of these enterprises. The Bangladeshi constitution was amended in 1977 by a Martial Law Proclamation Order to enable divestiture. In many countries, the constitution still prevents the divestiture of some SOEs, such as railways, postal services, telecommunications or natural resource SOEs¹¹⁴.

In Senegal¹¹⁵, Morocco¹¹⁶ and other countries with a constitution modeled on the French one,

¹¹¹ See Graham and Prosser (1991) for a thorough discussion of the constitutional requirements of privatization in the UK and France.

¹¹² Until April 1990, the Bulgarian Constitution stipulated that "the economic system of the People's Republic of Bulgaria is socialist. It is based on the public ownership of the means of production" (art. 13). The 1984 Constitution of Guinea-Bissau, which describes the country as "a sovereign, democratic, secular, unitary, anti-colonialist and anti-imperialist Republic" (art. 1), stipulates that the following are State properties, namely "the soil, subsoil, waters, mineral resources, main energy sources, forests, basic means for industrial production, mass-media, banks, insurance, roads and fundamental transport means" (article 12.2). See also section on property law of Chapter II.

¹¹³ Article 10 of Mozambique's 1975 Constitution states that "In the People's Republic of Mozambique the State economic sector is the leading and driving factor in the national economy. State property is given special protection, its development and expansion being the responsibility of all State organs, social organizations and citizens." Article 9 of Angola's 1975 Constitution is worded slightly differently: "The foundations of economic and social development are socialist ownership, consubstantiated in state ownership and cooperative ownership. The state shall adopt measures permitting the continuing broadening and consolidation of socialist relations of production."

¹¹⁴ Article 177 of the Brazilian Constitution gives the State a monopoly on exploration and exploitation of petroleum, natural gas and other hydrocarbons, on the refining of petroleum and on other ancillary activities. The Mexican constitution contains a similar provision.

¹¹⁵ Article 56 of the Senegalese Constitution of March 7, 1963 provides that: "The National Assembly shall hold the legislative power. It alone shall vote the laws. Laws shall establish the rules concerning: (...) the nationalization of enterprises and the transfer of enterprise ownership from the public to the private sector." As mandated by the Senegalese Constitution, Law No. 87-23 of August 18, 1987, enables the privatization of State-owned enterprises listed in a schedule annexed to the law.

a law (i.e. an act of Parliament) is required to authorize the transfer of majority State-owned enterprises to the private sector. Indeed, article 34 of the French constitution of 1958 stipulates that the rules concerning "the nationalization of enterprises and the transfer of the ownership of public sector enterprises to the private sector" shall be established by law.¹¹⁷

By contrast, the constitutions of other civil law countries are silent on the topic, in which case no law may be required. In Togo, divestitures have been effectuated without enabling legislation enacted by the Assembly. The 1979 constitution does not list privatization as a matter within the exclusive domain of the legislature¹¹⁸. Unlike its French model, it does not explicitly require legislative action to enable divestiture.

A country's constitution, legislation or legal traditions in effect may allow the government or other public bodies to divest without special recourse to the legislative branch¹¹⁹. In this case, no enabling legislation is required from a legal point of view. This situation prevails in most common law systems, such as in the UK¹²⁰, New Zealand¹²¹, Australia¹²² and Malaysia¹²³, where it is generally

¹¹⁶ Article 45 of the 1972 Constitution requires that "the nationalization of firms and transfers of firms from the public to the private sector" be subject to legislation.

¹¹⁷ In instances where enabling legislation would be needed to divest, but where speed, simplicity of implementation or the desire not to resort to parliament are overriding government concerns, enabling legislation may be bypassed altogether by using a privatization method other than divestiture, such as concessions or leases.

¹¹⁸ Article 32 states only that the "rules concerning (...) the creation, management, and supervision of public establishments shall be set by law". Public establishments or "établissements publics" are SOEs organized under public law. See pp. 6-7 above.

¹¹⁹ See also p. 41 below.

¹²⁰ Most UK privatizations required legislation in order to turn the SOE into a limited liability company whose shares could then be sold. For SOEs already organized under company law, such transformation was not required and the privatization could proceed without prior parliamentary authorization. This happened in the privatization of British Petroleum, for example. See Graham and Prosser (1991) at p. 83.

¹²¹ "In New Zealand, unless there is specific legislation to the contrary, the Government and individual Ministers of the Government are regarded as having power to sell Government assets. A notable exception is section 11 of the SOE Act which prohibits the sale or other disposal of shares in companies named in a schedule to the Act (being the SOEs established under the authority of that Act). This schedule included Post Office Bank Limited and Telecom Corporation of New Zealand Limited which have since been sold. Before their sale, the SOE Act was amended (in the case of Telecom by the Finance Act 1990) to remove the name of those companies from the schedule to the SOE Act." See Williams and Franks (1992), paragraph 200, p. 67.

¹²² "The natural reaction of Government lawyers is to legislate to achieve the result desired by the Government. Commercial lawyers, on the other hand, do not normally have that luxury and therefore seek more commercial means of achieving their client's objective. With privatisation the Government is seeking to turn a Government Business Enterprise into a commercial enterprise operating in the market place in exactly the same way as other corporations. (...) [W]hen it comes to legislation, we should legislate to the minimum degree necessary, rather than the maximum possible." See Sly and Weigall, pp. 66-7.

¹²³ In some cases, such as the partial divestiture of Port Kelang Container Terminal (1986), special legislation "was passed by Parliament to enable and facilitate the privatization exercise". In the Port Kelang case, the port authority did not have the proper powers under the Port Authorities Act (1963) to create a subsidiary governed by the Companies Act. The Port Authorities Act thus had to be amended to authorize the establishment of KCT (Kelang Container Terminal) as a subsidiary, a preliminary step to the sale of 51% of the equity in the new company to KTK, a joint venture between KN (a public enterprise; 80%) and POAL (a private, Australian company; 20%). In addition, the Pensions Act (1980) also had to be amended in order to allow employees of the new company to keep pension benefits accrued while working for the port authority. See "World Bank Conference on the Welfare Consequences of Selling Public Enterprises. Case Studies from Chile, Malaysia, Mexico and the U.K.", Chapter 13, footnotes 13 and 17, Washington, D.C., June 11-12, 1992.

assumed that, barring explicit prohibitions, the State has the inherent power to privatize public assets and enterprises without specific legislative authorization.

Where constitutions deal with privatization, the concerned provisions normally relate to the power or authority to privatize. A privatization law may be needed for other reasons, though, such as the need to transform a statutory corporation into a company organized under ordinary company law prior to divestiture¹²⁴.

Legislation on Public Property

Clarifying Public Ownership Rights

Generally, in order to sell property one must own it, or be duly mandated by its owner to do so. Although this may seem self-evident, one should further take notice that to be an owner, legally speaking, requires juridical personality, i.e. to have a separate and distinct existence as a matter of law. For example, in many countries, ministries do not have a distinct juridical personality and cannot own SOEs. They may, however, exercise the State's ownership rights over SOEs.¹²⁵

The power to alienate (i.e. transfer ownership) is a critical feature of ownership rights. The identity and legal status of the public owner of the property to be divested must thus be established from the start. In sales of assets or subsidiaries, the SOE (or State holding company) will often be the owner-seller¹²⁶, whereas the owner-seller in most other situations involving the sale of enterprises or shares will be the State. Provincial or local governments may also own SOEs and in many countries uncertainty exists as to which public authority is the actual owner or has the right to exercise ownership rights (e.g. Laos, Russia, Poland, and other countries in Eastern Europe).

Special Laws on State Property

Laws on State assets, land and/or property should be checked. In some countries, a general law, that may apply to SOEs, governs disposition of public assets. In Bulgaria, Poland, Guinea (until 1985), and other countries with a legal system inspired from the Soviet model, SOEs do (or did) not own their fixed assets, i.e. land, buildings, plant, machinery and in some cases also vehicles and furniture. Typically, the State financed the acquisition of such fixed assets and the SOE paid annual depreciation allowances to the State. Those assets remain the property of the State and may not be sold by the enterprise without prior authorization. When sold, proceeds normally revert to the State.¹²⁷ One

¹²⁴ See section on divestiture legislation below.

¹²⁵ In Poland, a State Treasury was established in the Ministry of Finance and given legal personality. The State Treasury is the legal owner of SOEs and State shares in SOEs. The disposal of the Treasury's SOEs or shares is the primary responsibility of the Minister for Ownership Change, however.

¹²⁶ Some divestiture laws provide, however, that the State can sell shares of SOE subsidiaries and/or receive the proceeds of such sales. See Graham and Prosser (1991) at p. 82 discussing such powers given to the State by the Oil and Gas Act 1982.

¹²⁷ In Bulgaria, the law was amended in February 1991 to allow SOEs to keep 40% of sale proceeds. See pp. 54-55 below.

should thus check who under a country's laws is authorized to sell SOE assets and how the proceeds of such sales are allocated.

In countries with laws inspired from the French system, there may be a distinction between assets belonging to the public domain¹²⁸ or to the private domain of the State, the latter being easier to alienate. Assets belonging to the State's public domain cannot be alienated without transferring them first to the State's private domain, which can only be done by law.

SOE Legislation

Legislation Governing SOEs to be Divested

The specific laws and regulations affecting SOEs in general, and the enterprise(s) to be divested in particular, also need to be checked, as some may need to be repealed or amended. Amendments to SOE legislation required for the purposes of divestiture may be broken down in two categories, namely those needed (i) to enable the divestiture, i.e. to give the government the power to sell the enterprise, or (ii) to put the SOE on a proper commercial footing prior to its privatization.

Legal Constraints to Divestiture

Divestiture may be constrained by existing SOE legislation. In New Zealand for example, the SOE law prohibited the privatization of certain listed public enterprises.¹²⁹ The legal principle of parallelism of forms --which would require that, in order to abolish or transform an SOE, the same legal instrument be used as the one used to create the enterprise in the first place-- may dictate specific (and possibly different) legal instruments for the divestiture of SOEs in a same country.¹³⁰ Finally, SOE legislation may place restrictions on the ability of SOEs to buy or sell shares in other companies¹³¹.

Legislation on Prior Restructuring

Prior restructuring of the SOE may be necessary to effectuate the divestiture transaction. This may require amendments to or abrogation of existing legislation or enactment of new legislation. The

¹²⁸ The public domain of the State consists of assets (1) owned by a legal person organized under public law, such as the State, a municipality, a province, or an "établissement public" (a type of SOE); and (2) dedicated to the public/collective use and exploitation. The State's private domain consists of all its assets that are not in the public domain.

¹²⁹ See p. 34 above.

¹³⁰ This principle, which is not universal, is sometimes sanctioned by law, as in Togo, where article 36 of the law of June 16, 1982 on companies with mixed (public-private) ownership ("loi organique No. 82-5 relative aux sociétés d'économie mixte") provides that "where an SOE was created by ministerial decree passed by the Council of Ministers, such SOE may be divested or liquidated only following the same procedure". Adjé Ayassor argues in a doctoral dissertation on privatization in Togo that the constitutional requirement that SOEs be created pursuant to a law implies that "divesting a public enterprise also requires a law". See Ayassor, p. 91.

¹³¹ Restrictions on the right of SOEs to buy shares may be desirable and are often included in privatization legislation. Indeed the purposes of the program could be defeated were SOEs to buy shares of other SOEs put up for sale by the government as part of the program. Restrictions on SOE's right to sell shares they own would slow down privatization, but may be required in some instances to prevent abuses and subject such sales to minimal rules.

extent to which prior restructuring is needed will largely depend on the legal status of the SOE, on its specific characteristics and on the chosen divestiture technique. Indeed, SOEs that are not organized under ordinary company law, for example, would need to be transformed prior to divestiture, if they are to be sold as a going concern with all their assets and liabilities¹³².

Prior restructuring may also be carried out as part of the divestiture and may be the object of negotiations between seller and buyer. The term "prior" only implies that the restructuring be done by the public owner before the sale, rather than by the buyer after the divestiture. The body entrusted with divestiture of SOEs should also have the powers to restructure such enterprises in order to make them more attractive to potential buyers by breaking them up, removing debt or carrying out other restructuring measures described below (besides fresh investment).

General or enterprise-specific SOE laws may include provisions limiting the enterprise's autonomy, such as the government's right to appoint (in addition to the directors representing the State as owner on the enterprise's board) a special representative with the power to suspend board decisions¹³³. The application of such laws to the SOEs to be divested will need to be repealed prior to or, at the latest, at the time of divestiture. Management and labor restructuring would often also be called for, with legal implications on contractual obligations, transfer from civil service to labor law¹³⁴, lay-offs, severance obligations, and other areas. The same applies to financial restructuring, where the legal aspects of debt restructuring, cleaning up of accounts, treatment of State guaranteed obligations or renegotiation of outstanding agreements¹³⁵ with lenders and donors will need to be considered.

In order to create a level playing field, any special privileges granted to the SOE relative to the private sector, whether subsidies, tax or customs exemptions, State guarantees (express or implied) on borrowings, public procurement preferences, cheaper inputs (e.g. power or petroleum), exemptions from competition laws, special labor provisions, or other advantages or protection, should be removed before implementing a divestiture¹³⁶, as was the case in most of New Zealand's privatizations¹³⁷.

Similarly, where an SOE is burdened with obligations not faced by its private competitors, such obligations will need to be removed. In many countries, for instance, SOEs were required to carry out

¹³² If, instead, the divestiture takes place through sale of specified assets and transfer of specified obligations, no transformation would be needed, but the remaining parts or shell of the SOE may need to be liquidated.

¹³³ This was provided, for example, in Senegal's SOE legislation until 1990, when law no. 87-19 of August 3, 1987 was abrogated and replaced by law No. 90-07 of June 26, 1990. The 1990 law removed many types of controls on SOEs.

¹³⁴ In Canada, when the sale of two SOEs (Nordion and Theratronics) was conceived, parliament included a provision in the respective privatization laws exempting them from the Public Superannuation Act, which provides certain retirement benefits to SOE employees. See Bill C-13, An Act to Authorize the divestiture of Nordion International Inc. and Theratronics International Limited, Statutes of Canada (S.C.) 1990, Chapter 4, Art. 11 (1990).

¹³⁵ Especially where such agreements include clauses limiting the transferability of the SOE or its assets.

¹³⁶ See section on protection of competition in Chapter II.

¹³⁷ For example, New Zealand's Coal Corporation lost its exemption from the requirement to obtain mining licenses. Likewise, New Zealand's Telecom was corporatized while the telecommunications industry was simultaneously being deregulated and opened up to competition. See Williams and Franks (1992), at p. 22.

social functions without proper compensation by the State¹³⁸. These social activities tend to be loss-making and financed through cross-subsidization from other activities. Where allocated to the SOE by law, these functions will need to be removed prior to the SOE's divestiture and, where appropriate, allocated to other bodies¹³⁹.

Many countries have tried to address these restructuring issues in a comprehensive way and adopted corporatization laws to this effect, either as a first stage preceding divestiture (e.g. New Zealand¹⁴⁰, Sri Lanka), as part of the divestiture legislation (e.g. Germany¹⁴¹, Czechoslovakia¹⁴², Nigeria, the UK¹⁴³, Argentina¹⁴⁴) or both¹⁴⁵. The term 'corporatization' usually implies the conversion of an SOE to a State-owned company organized under company law¹⁴⁶. A law is often required to authorize this conversion, as well as a change in the by-laws or articles of association of the concerned SOE. Corporatization normally includes many other aspects of restructuring discussed in this section, besides the SOE's change in legal status. It can be a difficult, staff-intensive process, raising a broad range of complex legal issues.

A critical issue in corporatization is whether the new, transformed company is legally the successor of the old SOE. If so, it would normally succeed to all rights and obligations of the SOE, including: (i) outstanding contracts, including labor contracts and contracts with suppliers and clients; (ii) pension obligations; (iii) contingent liabilities (e.g. for pollution or arising from any other law suit against the former SOE); (iv) liability for arrears, overdue or undisclosed obligations or debts; (v) right to collect amounts due to the former SOE; and (vi) benefit of State guarantees granted to obligations of the former SOE. Such universal succession might preclude a successful privatization, as buyers may be loath to take over some of the former SOE's obligations, in particular contingent and hidden liabilities. This problem

¹³⁸ Examples include provision of goods or services to certain categories of customers at a loss, and provision of health, education, housing and other social services to employees and their relatives, and sometimes even to a whole town (especially in the former Soviet Union).

¹³⁹ Alternatively, the State may enter into a contract with or grant a subsidy to the newly privatized company to continue the activity.

¹⁴⁰ The 1986 SOE Act is a corporatization law.

¹⁴¹ Other restructuring measures were further taken by the Treuhand, including renegotiation or cancellation of outstanding contracts. The Financial Times reported in an article on hotel privatization in eastern Germany that "one of the Treuhand's first steps last year was to revoke an operating contract between Interhotel and the Steigenberger hotel group in west Germany. It virtually ensured that Steigenberger would have gained control of Interhotel for a modest initial investment." (Financial Times, November 22, 1991, p.22)

¹⁴² See articles 11 and 12 of the Large Privatization Law of February 26, 1991.

¹⁴³ The laws authorizing the privatization of large enterprises typically provided for their prior transformation into limited liability companies. See Graham and Prosser (1991) at p. 78.

¹⁴⁴ See Law No 23696 on the Reform of the State (18 August 1989), and in particular articles 6 and 15 which authorize the government to change the legal form of all SOEs over a one-year period.

¹⁴⁵ As in Bulgaria, where corporatization provisions were included in a January 1989 law, later modified on many occasions, and finally incorporated in the April 1992 privatization law.

¹⁴⁶ Commercialization is similar though less far-reaching than corporatization, as it does not imply the incorporation of the SOE into a company organized under company law. It is also aimed at making the enterprise more profit-oriented and might include establishing commercial accounting and financial statements, introducing commercial objectives, allowing the body to choose its suppliers freely and setting up an autonomous board and management. The SOE would thus be run along commercial (or private) lines. Its legal status would still be public, however (see pp. 6-7 above).

can be circumvented, however, either at the stage of corporatization or of divestiture, by limiting the new company's liabilities and providing for State responsibility for the residual liabilities.

Another common problem, related to the succession issue, is the possibility that many SOEs might be technically bankrupt from the day of their corporatization. Indeed, corporatization not only implies that the new company be subject to ordinary company law, but also to other business laws, including the bankruptcy laws. For these and other reasons, financial restructuring may thus be required for corporatization as well as divestiture.

In Germany, all SOEs (with a few exceptions) were transformed overnight (as of July 1, 1990) into companies organized under the companies law¹⁴⁷. The Treuhandanstalt became the sole shareholder of the former combines (the equivalent of holding companies or conglomerates) reorganized as joint stock companies, whereas the constituent businesses of the combines were reorganized as limited liability companies owned by these new joint stock companies. Under a separate law¹⁴⁸, the new companies had to establish their opening balance sheet in Deutsche Mark. To this effect, all their assets and liabilities had to be reevaluated. Where liabilities exceeded assets, the shareholder (Treuhandanstalt or joint stock company owned by the Treuhandanstalt) had to decide whether to cover the shortfall or not. If it decided to cover such shortfall, the shareholder was then required to recapitalize the new company to the minimum level required by law. In addition, the Treuhand became responsible for interest payments on old SOE debt and took some liabilities over from the new companies in order to improve their balance sheet. This massive financial restructuring in part explains the Treuhand's high borrowing requirements in its first year of activity.

Similarly, in Czechoslovakia¹⁴⁹ and other countries¹⁵⁰, corporatization has been carried out through big State holding companies or funds¹⁵¹. Under some of these schemes, the old SOE is dissolved and a new company is set up under the companies law by the concerned fund, which transfers specified assets and liabilities to the new company against shares in the company. In a second stage, the fund divests itself of these shares. This two-stage procedure has many advantages, including dispensation of the need to establish a detailed inventory of assets and liabilities prior to divestiture; possibility to break up the old SOE in smaller companies, to regroup assets from different enterprises into one company, sell separately real estate belonging to the SOE, but not needed for the operations of the enterprise; possibility to leave the fund legally in charge of redundant workers, doubtful debt, environmental liabilities; etc. Any outstanding obligation of the old SOE, known or unknown, is taken over by the fund, which circumvents burdensome bankruptcy or liquidation procedures. The new company to be privatized can thus start with a clean slate.

¹⁴⁷ See sections 11 and 12 of the June 1990 Trusteeship Law.

¹⁴⁸ The Law on Financial Statements in Deutsche Mark of 1990. See Horn (1992), pp. 15-18.

¹⁴⁹ The SOEs to be divested were transferred with all their assets and liabilities to one of three state property funds.

¹⁵⁰ In Bulgaria, a bank consolidation company was established to take over all public participations in commercial banks and restructure the whole banking sector through mergers, liquidations and divestitures.

¹⁵¹ See also the discussion on voucher schemes and privatization funds below. The funds mentioned in this section are restructuring agencies that do not necessarily have divestiture functions. In the CSFR and German cases, the same agency combines both functions, however.

Some of the aspects or components of a corporatization program outlined above are often found in other types of pre-divestiture restructuring, that do not require a conversion of the SOE's legal status, either because the old SOE disappears altogether or because it was already incorporated under the country's company laws. For instance, when an SOE is broken up prior to divestiture, the old SOE is usually liquidated. This was a frequent occurrence in most Eastern European countries where this process is often referred to as "demonopolization". It can also be found in numerous other divestitures, such as the 1990 break-up of the Argentine National Telephone Company, whose assets were transferred together with an exclusive license to provide basic telephone services to two new joint stock companies, Telecom Argentina and Telefonica de Argentina, responsible respectively for the north and the south of the country. Such break-ups require *inter alia* an allocation of assets and liabilities to the new companies.

Powers of SOE Management and Board

General SOE legislation, enterprise-specific legislation and SOE by-laws will need to be checked to ascertain the powers of the SOE's board and management in the divestiture process. One critical dimension would be restrictions on the power to sell SOE assets, including financial participations¹⁵². In many instances, the SOE legislation or by-laws¹⁵³ will define the powers of SOE bodies, including shareholders meeting (if any), board of directors and the general manager, and set financial thresholds to demarcate their respective powers as well as the powers of the State.

Provisions may also deal with the authority to enter into binding contracts on behalf of the SOE (representations) and with sanctions against SOE officials acting *ultra vires* (i.e. beyond the scope of their powers). The overall concern should be to ensure that the SOE has enough flexibility to conduct its business efficiently, but not enough to sell off major assets or engage in asset stripping without control of the owner. The problem often arises from the absence of shareholders meetings or similar bodies and lack of accountability of SOE management and directors. Restrictions can be placed in the divestiture legislation on the latitude of SOE managers and boards to divest major assets as well as on the allocation of proceeds from such sales¹⁵⁴.

Legislation on SOE Liquidation

Different laws may apply depending on whether the SOE is organized under company law, in which case corporate bankruptcy laws would normally apply, or under public law, in which case bankruptcy may either not be possible or be subject to special rules. Some countries have enacted special legislation¹⁵⁵ on SOE liquidation and bankruptcy, which will have to be assessed along the lines

¹⁵² Separate rules often apply to State holding companies, although they may also be subject to restrictions on the sale of subsidiaries or financial participations.

¹⁵³ The by-laws of Air New Zealand restricted the ability to transfer shares. Indeed, company shares could only be sold to British subjects.

¹⁵⁴ See pp. 45 and 55-56 below.

¹⁵⁵ See, for example, Senegal's Law No. 84-64 on SOE liquidation (August 16, 1984) and Togo's Law No. 82-5 on companies with mixed (public-private) ownership (June 16, 1982).

indicated in the section on bankruptcy law¹⁵⁶. In others, such as Guinea¹⁵⁷, where liquidation was the preferred divestiture technique, the decision to liquidate specific enterprises may also have to be taken by law.

Other Public Law Matters

Authorized Officials

In the absence of specific divestiture legislation, one should refer to other laws and assess whether they are adequate to determine who has the legal authority to sell SOEs. The concerned official should be authorized to act on behalf of the owner. In Burundi, the SOE law designates the President as the only official authorized to divest the State of its shareholdings in a SOE governed by that law¹⁵⁸. In New Zealand, unless there is specific legislation to the contrary, the Government and individual Ministers of the Government are regarded as having power to sell Government assets¹⁵⁹. The same holds for most other common law countries. Irrespective of who is authorized to sell on behalf of the State, what matters most is the unambiguity of this authorization (whether explicit or implicit), which is needed to avoid later disputes. When SOEs are part of larger State holding companies, such as CORFO in Chile or the Egyptian State holding companies, the law establishing the holding company (if any) and/or its by-laws would determine whether the general manager or higher management bodies have the power to divest subsidiaries¹⁶⁰.

Public Finance Laws

The budgetary rules applicable to the allocation or use of divestiture proceeds should be clarified.¹⁶¹ Even where divestiture laws specify how proceeds are to be allocated, other public finance laws will apply. In many countries with a budgetary system inspired from the French one, for example, public expenditures may not be deducted from public revenues (no compensation or contraction of expenditures and revenues), as all public expenditures need to be authorized by the legislature and committed, disbursed and controlled by the authorized officials. The French Cour des Comptes (the equivalent of the U.S. General Accounting Office) criticized in its 1990 Annual Report the way in which

¹⁵⁶ See pp. 22-23 above.

¹⁵⁷ See ordinance No. 306 PRG-85 of December 12, 1985, which mandates the closure and liquidation of twelve listed enterprises, or ordinance No. 315 PRG-85 of December 21, 1985, mandating the liquidation of 34 rural retail outlets. An ordinance is the equivalent of a law in Guinea (a military regime).

¹⁵⁸ Article 6 of this law ("Décret-Loi No. 1/027 fixant cadre organique des sociétés de droit public et des sociétés d'économie mixte de droit privé" of September 9, 1988) states that "the State's shareholdings can be alienated only upon a decree of authorization taken [by the President] upon the advice of the minister of Finance and the minister controlling the SOE to be divested (ministre de tutelle)".

¹⁵⁹ "Where the New Zealand Government has been the seller (for example, of shares in an SOE), the usual practice has been for the Government Ministers who hold the shares on the Government's behalf to be responsible for the sale (with final approval being reserved to Cabinet) and for those Ministers to be advised by Treasury officials. Any sale agreement is usually signed by the responsible Ministers personally." See Williams and Franks (1992), at pp. 67 and 68.

¹⁶⁰ See also p. 40 above.

¹⁶¹ See pp. 54-56 below for a discussion of specific legislative provisions on the allocation of divestiture proceeds.

expenditures (mainly commissions and fees for financial intermediaries and taxes) linked to flotations or other divestiture transactions had been deducted directly by the banks from the gross amount received, resulting in a transfer of only the net proceeds of the divestitures they handled to the special Treasury account for divestiture.¹⁶² Also, public procurement regulations may apply to the recruitment of privatization advisors.

State Immunities

Though it may seem obvious, one should point out that a privatization is a transaction involving dealings between a private entity and a public one, usually a sovereign State. Under the laws of many countries, a State may, however, enjoy immunities from jurisdiction or suit in respect of claims brought against the State. The extent to which these State immunities should be preserved or waived by a sovereign State in the context of a privatization is an important question to answer, as it will have a direct bearing on the confidence of private participants, and therefore on the marketability and price of assets to be sold. Some privatization laws, such as the Philippine law¹⁶³, stipulate limited immunities from prosecution for the privatization agency and its members.

Prosecution of Fraud

Do laws in effect hold officials, whether SOE managers or board members, civil servants or other officials, accountable for their actions? Do they deal adequately with corruption, fraud, misallocation of public funds, collusion and similar behavior? In many East and Central European countries, such as Poland¹⁶⁴ or Hungary¹⁶⁵, initial privatizations were marred with allegations of fraud, which led to new, tighter legislation to control the divestiture process. In the absence of a normal legal framework for a market economy (such as securities regulations), many of these offenses were not strictly speaking illegal.

¹⁶² The Cour des Comptes also criticized the lack of transparency in the financial aspects of debt redemptions, in particular the losses incurred in the redemption of gold-indexed bonds. See Cour des Comptes, Rapport au Président de la République, Vol. III, pp. 28-9, 1990.

¹⁶³ See Section 32 of the 1986 Proclamation.

¹⁶⁴ "The auto-appropriation of state assets by the nomenklatura has been facilitated in Poland by the extraordinary growth of joint stock and limited liability companies founded in Poland, which were almost 30,000 in 1989. Some transactions, in which managers appeared on both sides as sellers on behalf of their state enterprises and as buyers for their own companies or even joint ventures - naturally have been declared void by the Supreme Court, but the bulk of this kind of transaction are unlikely to be challenged especially when foreign buyers are also involved. A famous case is that of Igloopol, the largest Polish agro-industrial complex, valued at 145 billion zlotys and artificially liquidated and transferred for 55 billion zlotys to a joint stock company with the same board of directors, whose shares -transferable at their discretion- were sold mostly to Party organizations and activists. The Ministry of Agriculture (of which the Igloopol Managing Director was Deputy Minister) approved the liquidation procedure in spite of a Ministry of Finance report which declared it illegal and economically unjustified. A recent decree of the Mazowiecki Government has now made illegal the participation of state enterprise managers and workers' councils in the companies founded by their own enterprise." From Nuti (1991), p. 66, footnote 13.

¹⁶⁵ See, for example, a discussion of fraud issues in the attempted privatization of HungarHotels in "Property Rights Reform: Hungarian Country Study", Keith Crane, in Blommestein and Marrese (1991), p. 88.

The Divestiture Legislation

Whether a country should enact divestiture laws or not depends on its legal and political situation and on the specifics of the enterprise(s) to be divested. Advantages of a law include: up-front and explicit political support and commitment for the process, increased accountability of the agency in charge of implementing the divestiture(s), and opportunity to add to the enabling provisions of the law other changes in the legal regime that may be needed to facilitate the divestiture process. Disadvantages include often lengthy delays needed to secure parliamentary approval¹⁶⁶, danger of overspecification of the law and of excessive parliamentary interference in the process. SOEs generally do not need special laws to divest their assets or subsidiaries.

Where needed, the contents of divestiture laws may differ dramatically. First, many divestiture laws address some of the critical shortcomings in existing legislation discussed in Chapter II and in the previous sections of this chapter. Such provisions may be referred to as the facilitating provisions of the law, as opposed to its enabling provisions. Second, laws deal differently with what one could call the core elements of divestiture legislation, i.e. the enabling provisions which deal explicitly with the divestiture process, authorizing and/or organizing it. Much of the discussion in this section assumes that special divestiture legislation is indeed required (legally) or deemed desirable (politically¹⁶⁷). A non-exhaustive list of divestiture legislation enacted worldwide is provided in Annex I.

Law vs. Other Instruments

Where divestiture legislation is required, it is normally preferable to limit the provisions of the law to the minimum possible, while leaving all details and implementation arrangements to subordinated legislation or decisions. There is, however, no universal recipe as to which divestiture provisions should be left to the discretion of the parties involved, and which ones should be included in: (i) the divestiture law; (ii) implementing decrees or regulations; (iii) decisions of the authorized official (e.g. minister of finance, chairman of the privatization agency); or (iv) general guidelines. This will in part be a function of the country's legal and political system and traditions (and of its constitution in particular), and in part be the result of political forces, such as the desire of members of the legislature to keep close tabs on the privatization process. Issues determining this decision include the government's or legislator's preference for flexibility vs. standardization, centralization vs. decentralization, and accountability vs. control, and

¹⁶⁶ This may happen even where the parties backing the government have a solid majority in Parliament. In Bulgaria, for example, a divestiture law was first drafted in April 1990 and submitted to the National Assembly as early as September 1990. Even though the government had an absolute majority in the National Assembly, and from January through October 1991 a majority of more than 80%, it was unable to get divestiture legislation enacted. The law was finally enacted by the National Assembly on April 23, 1992, i.e. two full years after the first draft had been prepared at the Council of Ministers, and despite the fact that since November 1991 the government no longer had a majority in Parliament. The difficulties tend to be compounded where the legislature is bicameral, i.e. where it consists of two houses, typically an upper house (Senate, House of Lords) and a lower house (House of Representatives, House of Commons, National Assembly). In Poland, for example, the government announced a new privatization program in June 1991 calling for a fast divestiture of about 400 SOEs through mutual funds, whose shares were to be sold to Polish citizens. But, the lower house of parliament, dominated by ex-Communists, managed to stall the plan by delegating it to the next parliament.

¹⁶⁷ Even though legally authorized to divest under existing laws, a government may wish to be covered politically through a vote of parliament.

should be identified at the outset, as they will have a direct bearing on the design of the legal framework for divestiture.¹⁶⁸

Furthermore, a law should not be used as a substitute for a proper divestiture strategy. Where this happens, the law tends to be burdened by many considerations that are better left to subordinated legal instruments. Many aspects of divestiture that appear critical from a strategic point of view, such as speed, timing or choice of specific divestiture techniques, should not be included in the law as it could easily become a straight jacket.¹⁶⁹ Strategies can be modified rather easily to adapt to changing circumstances or build in the lessons from new experience. The same is not true for laws.

General vs. Enterprise-Specific Laws

Whether required by Constitution or law, or not, most divesting countries have chosen to enact some type of divestiture legislation. This has led them to choose between general legislation applicable to all SOEs to be divested and particular laws for each such SOE or group of SOEs.

A general law should be considered if standardization is deemed important. It may list the SOEs which are to be either fully divested or partially divested; in this case, the government's authority to divest is usually limited to the listed SOEs, as in France (65 SOEs), Morocco (112 SOEs), Senegal (27 SOEs), Nigeria (110 SOEs), Burkina Faso (12 SOEs) or Argentina. It may also give the government or privatization agency a general mandate to divest SOEs, as happened in the Philippines, where the law stipulates that the President of the country is responsible for the identification of assets or SOEs to be divested¹⁷⁰. This privatization mandate may be limited through exclusion of specified sectors or SOEs, as was the case in the former East Germany, where transport infrastructure, the post office and municipal

¹⁶⁸ The French privatization legislation provides an interesting, though idiosyncratic, illustration of how identical provisions could be alternatively included in a divestiture law or implementing regulations. Article 5 of the first privatization law authorized the government to legislate by issuing ordinances on the basis of Article 38 of the French Constitution. President Mitterrand (a socialist) refused, however, to sign the ordinance prepared by the government of his Prime Minister, Jacques Chirac (a conservative). To circumvent this opposition, Mr. Chirac's government submitted the text of the ordinance to the National Assembly as a bill, which explains why two consecutive laws had to be enacted in July and August 1986, respectively, to enable the implementation of the privatization program.

¹⁶⁹ The Puerto Rican Telephone Authority Act of April 10, 1990, is a good illustration of an over-specified privatization law. It includes highly restrictive provisions, including: (i) minimum net proceeds to be fetched from the sale of the company, namely two billion US\$ after deduction of the total amount of the SOE's debt at the date of the sale and of expenses related to the sale of the SOE; (ii) tariffs for basic telephone service shall not be increased for a three year period following the privatization; (iii) the buyer is prevented from dismissing any employee as a direct result of the sale; and (iv) as a prerequisite of the consummation of the sale, the legislature will have to approve laws creating a Permanent Fund for the Development of Education, a Permanent Infrastructure Fund, the Puerto Rico Telecommunications Regulatory Commission and adopt a resolution proposing a constitutional amendment. These conditions, and in particular the minimum sale price (which amounted to about US\$3 billion), precluded the successful conclusion of negotiations with interested bidders. As the government had no flexibility to accommodate bidders' concerns, it had to withdraw the company from the market. In February 1992, the Government signed a deal for the privatization of long-distance services.

¹⁷⁰ See Article IV of Presidential Proclamation No. 50 of December 8, 1986.

enterprises were amongst the sectors excluded by the privatization law. Another option would be to determine the sectors in which divestiture may take place, without naming enterprises.¹⁷¹

By and large, we would advise caution in listing the SOEs to be divested in the law, as this may entail some risks. Uncertainty, fear of lay-offs and lack of incentives and accountability in the period preceding the actual divestiture¹⁷² could bring about the deterioration of the SOE's condition. This has been experienced in some countries, where a long delay between the identification of an SOE for divestiture and the start of the process resulted in the pilfering and dilapidation of enterprise assets by employees and managers. Furthermore, changing market conditions in the country concerned as well as worldwide may dictate other priorities for divestiture than those set out in the law.

A general law may also apply to divestiture by SOEs or State holding companies, i.e. to situations where the SOE is the seller rather than the State. In such case, the law might include a derogation from normal SOE or company law, such as the requirement that the proceeds, or part thereof, of divestiture by SOEs be allocated to the national budget¹⁷³.

Finally, a general law may subject different types of divestiture to different regulations. In France, for example, the privatization laws of July 2 and August 6, 1986 authorized three different divestiture procedures, namely: (i) sale by administrative decision for enterprises in which the State's direct shareholding is less than 50% and that became part of the public sector without legislative approval, and for partial sale of shares of majority State-owned enterprises where the State remains the majority shareholder after the sale¹⁷⁴; (ii) requirement of prior legislative authorization for divestiture of enterprises in which the State is a majority shareholder (over 50%) or that entered in the public sector pursuant to a law; and (iii) divestiture on the basis of specific rules and procedures set forth in the privatization law of July 2, 1986, for the 65 enterprises included on the list annexed to said law.

Specific laws enabling the divestiture of one or a few SOEs were enacted in the UK, Canada, New Zealand, Puerto Rico¹⁷⁵, and several other countries¹⁷⁶. Such targeted privatization laws are particularly indicated where the scope of the privatization program is limited or where an SOE or group of SOEs raises special legal problems that are not easily solved in the context of a broad enabling

¹⁷¹ See, for example, Bulgaria' Council of Minister's decree No. 36 of April 10, 1990, authorizing privatization of stores, workshops, hotels, restaurants and other establishments in the commerce, tourism and service sectors. This decree has since been repealed.

¹⁷² This period could span many years after the enactment of the law.

¹⁷³ See below pp. 55-56.

¹⁷⁴ See decree No. 91-332 of April 4, 1991, which sets the conditions on the basis of which minority shareholdings in public enterprises may be sold to private parties.

¹⁷⁵ See Puerto Rican Telephone Authority Privatization law of April 10, 1990.

¹⁷⁶ In Brazil, although, from a legal point of view, no law was needed to privatize VASP, the Sao Paulo state airline, one was sought for political reasons, namely to secure the Sao Paulo provincial government's commitment in anticipation of heated political opposition to this divestiture. See law No. 6629 of December 27, 1989).

law¹⁷⁷. This would typically be the case for the privatization of large, complex SOEs, like telecommunications companies.

Delegation of Authority

Most divestiture laws clarify the respective roles and powers of the key actors in the divestiture program, such as the legislature (parliament), the government, the privatization minister, the minister of finance, the agency(ies) responsible for divestiture, SOE holding companies (whether pre-existing or created specifically for the purposes of the privatization process), mutual funds, stock exchanges, SOE management and boards, and other actors. Rules would be set to ensure accountability of these actors, including, where relevant, reporting requirements to the council of ministers, parliament¹⁷⁸ or another body, and controls by a State audit agency or inspectorate.¹⁷⁹

These topics could be covered by existing public law or company law provisions, new provisions in the enabling law or in a special law, such as the law establishing a privatization agency (if different from the enabling law¹⁸⁰). From such provisions¹⁸¹, it should be possible to determine who has the authority to: (i) request the initiation of divestiture transactions (e.g. anybody, employees, enterprise management, board, ministry, local authorities); (ii) prepare the transaction; (iii) organize the selection of the buyer and/or negotiate the deal; (iv) authorize the conclusion of the transaction (e.g. privatization agency or council of ministers approving divestiture negotiated by another body, such as in the case of an asset sale by an SOE or a SOE sale by a municipality); (v) sign the related agreements; (vi) ratify such

¹⁷⁷ In the case of Petro-Canada, the Canadian government did not wish to privatize PCIAC, Petro-Canada's international assistance subsidiary. The specific law provided for the transfer prior to divestiture of Petro-Canada's PCIAC shares to the government. See Bill C-84, (Passed by the House of Commons on Dec. 18, 1990) proposing An Act respecting the privatization of the national petroleum company of Canada (Petro-Canada Public Participation Act).

¹⁷⁸ In addition to their role in passing divestiture legislation, some legislatures have given themselves a role in the implementation of divestiture. In Hungary, for example, the legislature initially placed the newly established Privatization Agency under its authority (Act VII of January 26, 1990 on Foundation of the State Property Agency with the purpose of Management and Utilization of Property belonging to the Agency). Less than a year later, the law was amended to place this agency under the authority of the Council of Ministers and the State Audit Office following criticism on the conduct of early privatizations. In some countries, parliament included provisions in the privatization law requiring parliamentary ratification of important transactions. Such involvement is not recommended, however, as it introduces additional uncertainty in transactions that are by and large already difficult enough to negotiate.

¹⁷⁹ In addition to designating the key actors, the legal framework should also include the "right" incentives and sanctions for a successful implementation of the divestiture program. Issues to explore include: ways to commit the key actors to the divestiture process, while avoiding conflicts of interests or responsibilities. Also, post-divestiture restrictions may be imposed, such as the prohibition for key State and SOE personnel involved in the divestiture to accept employment from one of the bidders for a given period after completion of the divestiture. For example, Tunisia's public enterprise law prohibits officials who represented the government or other public sector entities in an SOE from working in any capacity for such enterprise during a period of three years following the end of their mandate. This exclusion would apply to the privatized company as well. Violations of this rule are punishable by a fine ranging between 100 and 10,000 dinars, imprisonment for six months to two years, or both. See article 5 of Law No. 89-9 of February 1, 1989, relative to public shareholdings and public enterprises.

¹⁸⁰ See, for example, the Hungarian Law on the Foundation of the State Property Agency with the purpose of the Management and Utilization of such Property (January 26, 1990), or the Polish law establishing the Office of the Minister for Ownership Changes (July 13, 1990).

¹⁸¹ Or from the provisions of the applicable company or SOE laws with respect to SOEs selling their assets or subsidiaries. See p. 40 above for a more complete treatment of this topic.

agreements, where applicable¹⁸²; (vii) implement the divestiture agreements; and (viii) monitor their proper implementation by all parties. Similarly, one should examine whether the same rules of competence apply for divestiture, liquidations and enterprise restructuring (including break-up of SOEs and other repackaging of assets). It should not be assumed that one official or body could have the authority to do all the above. To the contrary, different bodies are always involved.

Legally speaking, there is no model or perfect institutional set-up for divestiture. What matters, however, is that, whatever structure is chosen: (i) the responsibilities of each agency or actor involved in the process be clearly identified; (ii) conflicts of interest be avoided; (iii) the agencies in charge of divestiture receive a broad mandate and corresponding powers to implement the program; (iv) the process be streamlined as much as possible to avoid endless bureaucratic haggling and interference, as well as overlapping responsibilities; and (v) controls be to the extent possible *a posteriori* rather than *a priori*. Bulgaria¹⁸³, Hungary¹⁸⁴ and Tunisia¹⁸⁵ offer examples of cumbersome or ineffective institutional set-ups that had to be modified through amending or abrogating legislation.

While there is no perfect institutional model, the above objectives may best be achieved by the establishment of a separate group or agency with broad powers to manage the implementation of divestitures. Such agencies range from a core team responsible for the management of the process but delegating its detailed implementation (e.g. the Mexican privatization unit created in 1988 at the Ministry of Finance, with delegation of main tasks to commercial banks acting as agents for the government) to large agencies with vast resources for implementing the process directly (e.g. German Treuhandanstalt).

Basic Safeguards

Where divestiture legislation has been deemed necessary, parliaments and governments have often included safeguards in the legislation to reduce some of the risks typically associated with divestiture. Additional safeguards can also be built into divestiture contracts.

¹⁸² In Guinea, a country that did not enact a privatization law, transactions were concluded by the concerned cabinet member (usually the Minister of Industry) and the investors and then ratified by a presidential ordinance (the equivalent of a law). One of the objectives of this procedure was to overcome or cure any illegality that might be included in the agreements or in the way they were concluded. Their ratification by law exempted them from the application of other laws that they might have violated.

¹⁸³ In Bulgaria, the Council of Ministers set up a Privatization Agency by decree No. 16 of February 8, 1991. The agency's mandate was ambiguous, however, and primarily of an advisory nature. The coalition government in power at the time appointed a socialist as head of the agency. One year later, the agency had not yet accomplished anything of significance, the privatization law had not yet been enacted, and the small privatization program launched in 1991 had come to a halt. These delays were to a large extent due to political in-fighting and compromises reflecting the lack of confidence between the various groups involved, namely: between parliament and the government, between different parties and party factions in parliament, between members of government and between parliament or government and the privatization agency. A privatization law was finally enacted in April 1992, which calls for the establishment of a new privatization agency to replace the one set up in 1991.

¹⁸⁴ The initial privatization law provided that the State Property Agency had to report to Parliament. This system proved extremely cumbersome and inefficient and the law was later amended in favor of SPA reporting to the Council of Ministers.

¹⁸⁵ Law 87-47, which authorized the divestiture of SOEs mandated the involvement of three different committees in the divestiture process, namely (i) a committee for the restructuring of public enterprises (art. 4); (ii) a ministerial committee (art. 7); and (iii) an oversight committee at the stock exchange (art. 9). Additional powers were vested with various ministers. This law proved to be too cumbersome to implement and was abrogated and replaced by law 89-9, which only calls for the establishment of one committee for the restructuring of public enterprises.

The law might set broad guidelines, including minimum requirements and criteria for the selection of buyers and the organization of bidding procedures¹⁸⁶, while leaving it up to the implementing agency to adopt more detailed regulations and tailor bidding requirements to the specifics of each SOE. Decentralization of these matters should be accompanied by strong accountability of the responsible officials and in some instances also by oversight and recourse mechanisms or mandatory *ex post* audits. The selection of buyers is obviously highly sensitive, due to concerns prevalent in many countries about corruption, nepotism, foreigners or specified minorities or ethnic groups. A proper selection mechanism is important in many ways. If the selection process is organized in a truly competitive manner, the price offered for the SOE should reflect the enterprise's current market value, and prior valuation of the SOE becomes less relevant. As a result, one may be able to skip the formal valuation step, hence saving time and valuable resources.

Valuation of SOEs or public assets tends to be a delicate issue, partly because State officials want to protect themselves from any accusation of "selling off the crown jewels". Valuation gives them the political insurance or shield needed in case the decision to sell at a given price becomes controversial ("this was the price at which the SOE was valued by the auditors"). Not surprisingly, many countries have enacted laws requiring prior valuation. Nonetheless, it is in general preferable to rely on a transparent and open sale process with wide distribution of information rather than on expert valuation as a pre-condition to sale. Indeed, even in industrialized countries, valuations carried out by highly qualified experts are frequently well astray from the company's market value. Where the State sells shares to the public at a fixed price, however, as is usually the case with public offerings, valuations will need to be carried out in order to determine the offering price.

Where required, valuations should be carried out by independent and qualified persons and in accordance with commonly accepted valuation principles. Valuation rules and principles established in the context of compensation of private owners and shareholders of nationalized enterprises may be helpful as well, at least when these were developed with due respect for the rights of the expropriated owners (e.g. the French nationalizations of 1982¹⁸⁷). It is unwise, however, to attempt to prescribe a general valuation methodology. A case by case approach should be followed depending, *inter alia*, on the specifics of the SOE's industry and the nature of the assets.

Valuation should in any event only be a guide to the selling agency and the legislation should not prevent this agency from concluding a sale at a price below the estimate, if, at the end of a competitive selection process, no responsive bid has been received at or above such estimate. Prior valuation by independent professionals may be beneficial as a general reference price which will help the seller in his decision to accept bids and as a way to limit covert deals between the buyer and the officials in charge of the divestiture. It is, however, expensive and time-consuming and can not be carried out in a meaningful way in countries or sectors where market prices do not exist. Moreover, contemporaneous

¹⁸⁶ Another example would be provisions specifying how planned divestitures must be advertized. In France, the law provides that shares are normally sold on the financial markets. The minister in charge of privatization may, however, decide to sell such shares directly to interested buyers under specific conditions, which include that the planned divestiture be advertised (one month in advance of the deadline for receipt of bids) in the Journal Officiel and two financial journals with wide distribution. This ensures that adequate notice is given to all interested parties. See French Decree No. 86-1140 of October 24, 1986.

¹⁸⁷ See, for example: Jean-Jacques Israel, "La commission administrative nationale d'évaluation des actions des banques nationalisées non inscrites à la cote officielle (art. 18 de la loi du 11 février 1982)", *Revue du Droit public*, LGDJ, 4-1986, July-August 1986, pp. 971-1013.

controls, *ex post* audits, performance incentives and proper regulations against fraud and corruption should enable the government to keep its officials honest.

Authorized Techniques

All too often, divestiture laws and regulations have restrictively determined the authorized methods and techniques of divestiture. From a legal point of view, one should first examine what techniques would be authorized in the absence of specific provisions in the divestiture legislation. If needed, provisions could then be included in the legislation authorizing additional techniques or restricting the use of some techniques, as the case may be. Implementing regulations will often provide further details on how such techniques may be used.

The law should be broad, leaving the selection of the appropriate methods of divestiture to the discretion of the executing authority, or, at least, allowing the use of a wide range of divestiture techniques (and combinations thereof) to fit the specific requirements of individual transactions. Liquidation should in any case not be precluded, as this tends to be the only or the best way to divest some SOEs. Where standard techniques are set forth in the law, other techniques should also be allowed on the basis of minimum guidelines, such as the obligation to obtain ministerial approval to resort to non-competitive divestiture processes (e.g. direct sales to one buyer). Such provisions may be found in the laws of Czechoslovakia¹⁸⁸, Poland¹⁸⁹, France¹⁹⁰, Nigeria¹⁹¹ and Argentina¹⁹², amongst other countries. Indeed, most legislatures are neither particularly familiar with divestiture techniques nor prescient about what specific circumstances might arise that would call for special approaches in individual transactions.

Most techniques are well known and tried in the private sector, where mergers and acquisitions are frequent. Some others are specific to divestiture of SOEs and may need to be included in the divestiture law if the government wishes to use them. Voucher or coupon schemes are a prime example. They have been tested in a number of countries such as Chile, Mongolia, Canada¹⁹³ and

¹⁸⁸ Article 10 of the law concerning the conditions for transfer of state assets to other persons (February 26, 1991).

¹⁸⁹ Article 23.2 of the Polish privatization law provides that the Council of Ministers, upon recommendation of the minister of ownership transformation, may in specific cases authorize divestiture procedures other than those provided in article 23, namely auctions, public offerings and competitive tenders. On this basis, the Council of Ministers issued a special permit to authorize the sale of two thirds of the shares of Polam Pila, a producer of electric lights, to Philips of the Netherlands (See East European Business Law, July 1991, p.6).

¹⁹⁰ Article 4 of law of August 6, 1986, authorizing the minister of the economy to divest shares without going through the financial markets ("hors marché").

¹⁹¹ Article 4(3) of the Nigerian Privatization and Commercialization Decree 1988 provides that "[W]henver the Technical Committee is of the view that any enterprise is not suitable for disposal by public issue of shares, the Technical Committee shall recommend to the Federal Military Government the mode of disposal of such enterprise."

¹⁹² Article 17 of law 23696 provides a non-restrictive list of privatization methods, while article 18 sets forth the selection procedures to be followed in all cases, stressing competition and transparency.

¹⁹³ The 1979 partial give-away of British Columbia Resources Investment Corporation (BCRIC) was effectuated to answer the public's concern that they were being "asked to buy what [they] already own" and "the perception that the government was selling out to the rich." In this case, shares were also offered to the general public for payment. See Vuylsteke (1988), Vol I at p. 14; citing T.M. Ohashi and T.P. Roth, Privatization: Theory and Practice: Distributing Shares in Private and Public Enterprises, pp.

Czechoslovakia, and are now being introduced in several Eastern European countries and former Soviet republics to divest large numbers of SOEs at once in what is sometimes referred to as a mass privatization program.¹⁹⁴

Different techniques may also be combined, as was the case in many French privatizations where the government selected a stable core of large industrial or financial shareholders¹⁹⁵ and sold the remaining shares to the public at large through public offerings. This scheme was a critical element of the French privatization program and was meant to secure a group of committed owners, who would appoint a strong management team and prevent the atomization of shareholdings as well as the risk of uncontrolled take-overs. These core shareholders had to pay a premium above market for their stakes and were obliged to hold on to their shares for a specified period of time.¹⁹⁶ Similarly, Mexico, Argentina and other countries privatized their telephone companies in stages, starting with the sale of a controlling interest to a core group of investors (including a telephone operator) and following later with public offerings.

Preferential Schemes

State subsidies, discounts, rebates, free shares, concessional financing facilities and other preferential schemes with an impact on public finances may have to be authorized by law in many countries. Most of these schemes and related clauses are not essential parts of the legal framework for divestiture. They are mentioned here because they are found in a number of countries and are often considered when divestiture legislation is being prepared.

If some buyers are to receive a discount, rebate or free share allocation, or if special financing is to be provided for the acquisition of shares or assets, the divestiture legislation should set the minimum terms and conditions of such benefits or concessional terms, as this would constitute a loss of revenue for the State Treasury and represent a transfer of resources from the State to a specified group. Such

1-105 (Part One: Privatization in Practice: The Story of the British Columbia Resources Investment Corporation"), The Fraser Institute, Vancouver, 1980. See also Stanbury (1990).

¹⁹⁴ Several variations on the mass distribution / voucher theme have been offered. Some of the differences include whether: (i) the shares of the SOEs to be divested are given to one or more funds or directly to the public; (ii) the scheme applies to all SOEs to be divested or only to a part; (iii) SOE or fund shares or coupons are sold or distributed free of charge; (iv) vouchers or coupons can be exchanged or negotiated freely, or are non-transferrable; (v) coupon holders can bid directly for company shares or only for fund shares; and (vi) oversubscribed issues are reoffered at a higher price or subscriptions scaled down to match the supply. Under most of these schemes, special legislation would need to be enacted to create, authorize or regulate these funds. The legal complexities are significant and cannot be addressed in any detail in this paper. See English (1991), "Privatization by General Fund; Economic Empowerment for Central and Eastern Europe".

¹⁹⁵ This was an exception to the general rule of public offering of shares through the financial markets, allowed by article 4 of the August 6, 1986 law, which authorizes the Minister in charge of the Economy to choose the buyer without going through the financial markets after consultation of the privatization commission and on the basis of a decree setting minimum publicity and other requirements (see decree 86-1140 of October 24, 1986).

¹⁹⁶ The size (or capital share) of such cores varied from one case to another (typically between 20 and 30% of the capital base) and the control premium ranged from 2.5% above the public offering price for Paribas to 10% for Matra. The premium for TF1, the television station privatized pursuant to a different law, was 73%. See Cour des Comptes (1990), p. 27.

preferences have been granted to employees (e.g. Poland¹⁹⁷, France¹⁹⁸), lessees (e.g. Czechoslovakia¹⁹⁹), small shareholders (e.g. France) and citizens (e.g. Romania, Czechoslovakia²⁰⁰), amongst others. Article 16 of the Argentine privatization law²⁰¹ lists five categories of purchasers eligible for preferences, namely: (i) existing shareholders; (ii) employees; (iii) regular users of the services of the SOE to be privatized; (iv) producers of raw materials processed by the SOE to be privatized; and (v) individuals or companies bringing new sale contracts to the SOE.

Employee preferences are very common in divestiture laws. If not properly designed, they could become a barrier to effective privatization, however. They raise questions of equity (why should employees of some SOEs get a government hand-out and not those of other SOEs, or civil servants, farmers or the unemployed, to cite but a few), efficiency (does employee participation in company capital and/or profits contribute to higher efficiency, or not) and effectiveness (are they needed to coopt labor and hence secure a successful outcome for the divestiture program). The matter becomes even more complex when detailed regulations are considered²⁰². Various modalities have been proposed to reduce the risks associated with employee preferences, including issuing preferential employee shares without voting rights.

¹⁹⁷ Article 24 of the Polish privatization law provides, *inter alia*, that up to 20 per cent of shares are reserved for workers of the company at a 50 per cent discount on the sale price to the general public (Polish citizens). The aggregate value of the discounts granted to employees of a company is capped, however.

¹⁹⁸ The French privatization law of August 6, 1986 stipulated that 10% of the shares offered for sale had to be set aside for the employees (and some former employees); it authorized discounts for employees of up to 20% of the share price and a deferred payment plan over a maximum period of three years, provided the employees held on to their shares for a minimum period; it also authorized a discount of up to 5% for employees paying cash (no minimum holding period requirement). In the case of Paribas (a large commercial bank), for example, 10% of shares sold were reserved for employees (and former employees), with one third of these shares sold with a 20% discount and deferred payment (over two years) and two thirds cash with a 5% discount. In addition, free shares could be allocated to employees holding on to their shares for at least one year after the mandatory holding period (one free share for one bought and held for one year following full payment, in the case of Paribas) and to small shareholders who kept their shares for a minimum period of at least 18 months (18 months in the case of Paribas). The Cour des Comptes (1990 Report, *supra*, p.27) estimated the total cost (in lost revenue) of these advantages given to employees and small shareholders at slightly more than FF1 billion for employee discounts and slightly more than FF5 billion for free shares, equivalent to a total discount of about one billion US\$ equivalent (at 1991 exchange rates).

¹⁹⁹ See article 16 of the Small Privatizations Law, which gives lessees the right of first refusal on the property they are leasing by giving them the opportunity to purchase such property before it is put up for auction. The sale price is the starting price that would have been used for the auction (article 8).

²⁰⁰ Voucher or coupons schemes are being used in CSFR and other former communist countries to promote quick mass privatization and widespread share distribution. Article 22 of the CSFR large privatization law provides that: "1. An investment coupon (...) is a security that gives the bearer the right to purchase those stocks specified for sale for coupons. Said coupon is non-transferable and the rights associated with it pass only to a rightful heir. 2. The above-mentioned coupon may not be redeemed." Article 23 specifies *inter alia* that these coupons are issued and sold by the Federal Ministry of Finance. Article 24 stipulates that "Each Czechoslovak citizen who has permanent residency on the territory of the Czech and Slovak Federal Republic and who has reached the age of 18 years by the date of issuance of the coupons is entitled to said coupons." The first wave of voucher privatization took place in CSFR in June 1992. See also pp. 49-50 above for a brief discussion of these schemes.

²⁰¹ Law No. 23696 on State Reform of August 18, 1989.

²⁰² Who should be eligible for employee shares?: current employees (including those who joined recently; what should be the cut-off date?), former employees (minimum number of years of service?), retired staff, temporary or only permanent employees, etc. Should any restrictions be put on the transferability of these shares, such as restricting them to sale to other employees only, mandating a minimum holding period, imposing a forced sale when the employee leaves the company, etc.

Other ways should also be explored to secure employee participation, such as selling the SOE to a buyer or group of buyers, with a firm contractual undertaking to resell a minimum percentage of shares to employees on the basis of predetermined criteria. The buyer would factor the cost of the discount into his bid, which ensures transparency and comparability if different buyers want to change the mix of employee participation. In Mexico, unions were given the right of first refusal in divestiture, allowing them to buy a company by matching the winning bid²⁰³. Employee participation can also be promoted through interest free loans or installment plans to employees for the acquisition of shares²⁰⁴. Employee ownership is not a right, however, and as such should not be included as a standard feature in a divestiture program. Enabling language allowing (without mandating) employee preferences can be included in the legislation, if indeed it reflects the government's policy.

Financing

Cash payment should be the rule²⁰⁵. Special financing techniques have been included in many divestiture laws or programs. They include deferred payment (seller financing) and credit (bank financing). Such special financing arrangements may have to be authorized as part of the legal framework if they include a concessional element granted by the State on a selective basis (see previous section). In the absence of such concessional element, i.e. when the financing method has no adverse impact on the State budget or is available to all interested buyers, no special legislation should be required. Indeed, if concessional financing is offered to all interested buyers, it becomes part of the general terms and conditions (and in fact an element of price) and is no longer a preferential scheme. Techniques exist to reduce some of the risks associated with limited up-front equity put up by the buyers. Where shares are payable in installments, for example, the voting power of shareholders who have not paid the full amount of their shares can be limited and their shares may be held in escrow accounts until the last installment is paid.²⁰⁶

Debt instruments have been allowed in payment, especially in heavily indebted countries, such as Brazil, Argentina, Chile, Mexico and the Philippines, but also in France and other less indebted

²⁰³ "The unions have, by law, a right of first refusal at each sale. That is, once the bids are known, the union can acquire the company by matching the highest bid. Many enterprises have been sold to their respective labor unions under this provision -- a total of 16 in the period 1989-91 alone. (...) One key measure to prevent abuse of this labor protection is the prohibition of resale. This prevents an outside bidder making a deal with the union to buy the enterprise after the union has exercised its right, thereby obviating the need to bid in the first place." *From* "World Bank Conference on the Welfare Consequences of Selling Public Enterprises. Case Studies from Chile, Malaysia, Mexico and the U.K.", Chapter 15, Section II.C.5, Washington, D.C., June 11-12, 1992.

²⁰⁴ Loans and installment plans have some draw-backs, however, and should not be granted for the full amount of the share purchase. If loans are provided by the company directly, the total amount of loans for employee share acquisition should be small in relation with the company's capital base in order not to be prejudicial to company creditors and other shareholders.

²⁰⁵ *See*, for example, article 8 of the Senegalese privatization law, which states that "Except when exceptionally authorized by decree, shares for sale shall be paid in full and in cash."

²⁰⁶ Important financing issues may arise when the government is a creditor of the SOE to be privatized. As a result of the divestiture, the government may become in effect a creditor of the divested company. These types of issues are in general better addressed through prior restructuring or at the transaction level. The government can settle its accounts with the SOE by requesting that the purchaser pay all outstanding debts of the SOE as part of the divestiture package. The government may also consider forgiving the debt in whole or in part. Finally the government may want to retain some control over the management of the SOE to ensure repayment of the SOE's debts, for example through the use of golden shares (*see* pp. 56-58 below).

countries. The key factor is the determination of the value of the debt, i.e., for many developing countries, the discount rate at which these securities will be traded-in for shares. In Brazil, the discount rate for foreign debt-equity conversions was set at 25%.²⁰⁷ In the divestiture of Mexican steel companies, the conversion terms were set by a formula in the bidding documents.²⁰⁸ In France, the privatization law gave the option to pay for shares with State bonds; a ministerial arrêté determined for each privatization the bonds which could be traded in and their trade-in value.²⁰⁹

Each debt security issue accepted in payment of shares should normally have its own, different, discount rate reflecting its market value. The conversion or discount rate can either be set in the bidding documents or at the time of payment, and should not include an implicit subsidy to the buyer of the SOE.²¹⁰ Both approaches have their problems, including: (i) fluctuation in market discount rate and/or exchange rate between the issuance of the bidding documents, the opening of bids, the selection of the buyer and the signing of the agreements; (ii) the effect of the privatization process on the discount rate itself; and (iii) the risks and costs incurred by bidders in making a debt-based offer, such as their ability to acquire the necessary debt at the expected price, the availability and cost of adequate option or hedging instruments and the risk of acquiring debt if the deal does not go through.

Such debt-equity swaps may be governed by the divestiture law, public finance legislation (in respect to retiring government debt), a special law or regulation on conversion of debt to equity (which may predate the divestiture law and apply to conversion of public sector as well as private sector debt), or provisions included in the bidding documents for the concerned divestiture. The feasibility of carrying out debt-equity swaps may further depend on (i) the terms of the instruments establishing the debt being swapped (e.g. loan agreements between the concerned SOE and its lenders; government debt from foreign banks; government bonds), and (ii) regulatory constraints affecting the creditors (e.g. in many countries, commercial banks are not allowed to hold equity in non-financial enterprises). The matter is particularly complex where foreign banks have to grant waivers. Such waiver was critical in launching the tender for Entel, the Argentine telephone company, which was split up in two regional companies offered for sale in June 1990 for a minimum of US\$214 million cash and US\$3.5 billion in public debt.²¹¹

²⁰⁷ "Law No. 8031 of April 12, 1990, which regulates the Brazilian Denationalization Program (PND), established that shares in companies to be privatized could be paid for with past due credits with the federal government, and also with blocked funds on deposit with the Central Bank." Resolution No. 14 of the PND Directive Committee lists the financial instruments that may be used in the acquisition of companies being privatized in the context of the PND and sets rules for their conversion into cruzeiros. Accepted instruments include blocked currency, various public sector bonds, debt notes, privatization certificates, and foreign and domestic debt of the government. Privatization certificates, which could only be used as payment for shares in SOEs being privatized, were created pursuant to law 8018/90 which forced financial and other institutions to acquire such certificates. (Source: Legal Letter, Pinheiro Neto - Advogados, August and September 1991) After the four first divestitures carried out in 1991, the government had raised US\$1.69 billion, of which only US\$125 million was actual cash.

²⁰⁸ See Financial Times, October 15, 1991, p. 26.

²⁰⁹ See Cour des Comptes (1990).

²¹⁰ The discount rate on the outstanding debt could also be left as a variable in a tender procedure, but this would unduly complicate the evaluation process by requiring a rather sophisticated system to compare different financial offers.

²¹¹ The final price paid by the winning parties amounted to a total of US\$214 million in cash and US\$5 billion in debt instruments.

Allocation of Divestiture Proceeds

In most developing countries and former socialist countries, the net financial balance of divestiture is likely to be negative, i.e. divestiture-related costs are likely to exceed divestiture proceeds. In these cases, the determination of priorities for the allocation of divestiture proceeds should be noncontroversial, namely they should be used to cover the related costs. By and large, the allocation of such proceeds is a fiscal matter that should be governed by public finance regulations and be subject to parliamentary scrutiny. Many countries have rightly chosen to earmark divestiture proceeds to financing the costs associated with the privatization program, including debt write-offs, payment of advisers and other divestiture-related costs. To the extent total proceeds exceed total costs and as these net proceeds tend to be one-time revenues, economists usually recommend that they be allocated to debt repayment or similar deficit-reduction expenditures (as opposed to current expenditures).

The divestiture strategy or program should specify how divestiture proceeds are to be used. If the country's existing laws (including public finance and public enterprise laws) include no provisions to that effect, or if these provisions are not deemed appropriate for the use of divestiture proceeds, the divestiture legislation may need to include language on allocation of proceeds. Issues include whether the proceeds should be: (i) allocated to a special account or fund earmarked for specified expenditures, as was the case in Mexico²¹², France²¹³, Bulgaria²¹⁴, Czechoslovakia²¹⁵, Hungary²¹⁶, and Puerto

²¹² In Mexico, a special fund was set up to collect the proceeds of the privatization of commercial banks.

²¹³ In France, a special Treasury account was set up under law No 86-824 of July 11, 1986 (first amending finance law for fiscal year 1986) to collect all divestiture proceeds. On the revenue side the privatization account is credited with the receipts from sales of shares, certificates or other securities and rights on enterprises whose transfer to the private sector has been authorized by law. This account was not to receive the proceeds of shares or rights sales in enterprises not covered by the divestiture law (e.g. where such sales could be carried out without parliamentary authorization). On the expenditure side, the privatization account could be used for: (i) public debt reimbursements through transfers to the fund for the redemption of the national debt, the national industry fund and the national banks fund; and (ii) for capital contributions to State-owned enterprises through transfers to another special account. Of the FF 86 billion privatization proceeds collected in the 1986-88 period, two thirds were used for debt redemption and one third for SOE capital contributions. Like for other special Treasury accounts, operations on this account were subject to parliamentary approval as part of the budgetary process. The inclusion of such special account in the normal budgetary appropriations process, and its submission to parliamentary scrutiny, are critical to ensure transparency and consistency with approved objectives and procedures. See Cour des Comptes (1990).

²¹⁴ Article 6.1 of the April 1992 privatization law stipulates that privatization proceeds shall be allocated to a special account to be used to finance five separate special funds, namely a privatization fund (to cover expenses), a mutual fund (whose shares are to be distributed to the population, former owners and insurance funds), social insurance funds, a reconstruction and development fund and an agricultural fund. Such detailed earmarking is not recommended, however, as it may unnecessarily constraint the best use of such proceeds. Moreover, as pointed out above, experience shows that in many countries a significant part of the proceeds may be needed to cover the costs of privatization.

²¹⁵ Article 12 of the large privatization law.

²¹⁶ Article 18 of the State Property Agency law of 1990 allocates privatization proceeds to the agency and determines the expenditures that can be covered with such proceeds. These include privatization-related costs of the agency, SOE management and restructuring costs incurred by the agency, reduction of State debt and other purposes as determined by separate laws.

Rico²¹⁷; (ii) considered as general government revenue, as in New Zealand or the UK; or (iii) a mix of both systems, as in the Philippines²¹⁸ and Germany²¹⁹.

If special accounts or funds are established, the law or implementing regulations should determine how these should be set up, operated and monitored. For example, who decides on the use of these funds (a minister, the cabinet, trustees, the head of the privatization agency); how are they invested; do these funds earn interest and, if so, to what account is accrued interest allocated; can interest and principal be used for the earmarked purposes, or interest only. Under most legal systems, divestiture proceeds would be considered as public revenue subject to public finance laws, rather than free revenue to be used by the government without constraints for any purpose it sees fit. Expenditures financed out of these proceeds are thus normally subject to parliamentary authorization and scrutiny.

The case may be somewhat more complicated when SOEs sell part of their assets (e.g. a division, factory or subsidiary) to private investors.²²⁰ Under normal company law (and many public enterprise laws) the proceeds would revert to the seller, i.e. the SOE. This may defeat the purpose of the divestiture program, in cases where the objective was to reduce the size of the public sector or obtain budgetary revenues. Of course, as sole or majority shareholder, the State should be in a position to recover the proceeds from such divestitures or part thereof through dividends or repayment of outstanding SOE debt. In practice, however, this may never happen due to poor oversight of SOEs, lack of clear dividends policy, fraud or collusion between board members and management. In a number of countries²²¹, privatization provisions determine how the proceeds of such asset sales are to be allocated.

²¹⁷ The law authorizing the sale of the Puerto Rican telephone system provided that out of total net proceeds, at least one billion US\$ should be allocated to the Permanent Fund for the Development of Education and at least one billion US\$ to the Permanent Infrastructure Fund. Income generated from these funds would be used exclusively for financing projects in these two sectors. This transaction was never concluded, however. See also footnote 167 on p. 44 above.

²¹⁸ Section 34 of the privatization law provides that privatization proceeds, net of expenses incurred by the Asset Privatization Trust, form part of the general fund of the national government and should be remitted to the national Treasury immediately upon receipt. The Trust may, however, retain with the approval of the cabinet-level privatization committee, "such portion of the proceeds as may be necessary to maintain a revolving fund to be utilized for the payment of fees and reimbursable expenses and meeting the costs and expenses incurred by the Trust in the conservation and disposition of the assets held by it, or otherwise in the performance of its responsibilities under this Proclamation".

²¹⁹ Article 5.1 of the Treuhand law stipulates that "income of the Treuhandanstalt shall be used primarily for the structural adjustment of enterprises (...) and secondly for contributions to the State budget, and to cover current expenditure of the Treuhandanstalt. Income shall be used in agreement with the Council of Ministers." Article 25 of the unification treaty of August 1990 provided that "revenue of the Treuhand may also be used in individual cases for debt relief to agricultural enterprises". The same article also increased the Agency's power to borrow to a maximum of 25 billion Deutsche Mark, which ceiling could be further extended by decision of the federal minister of Finance. As it happened, the agency has had to borrow rather heavily to cover its expenditures.

²²⁰ Where the sale is an initial offering of freshly issued securities (primary offering) by a company, the sale proceeds would of course revert to the enterprise. This would not be a divestiture, however.

²²¹ Under Bulgaria's transitional privatization legislation (art. 13 of decree 56, as amended on February 28, 1991), for example, 40% of such proceeds were to be allocated to the enterprise, 30% to a sovereign debt servicing fund and 30% to the State Investment Fund.

In others, such as Brazil²²², the matter was hotly contested between the finance ministry and the selling SOE.

Some laws specify how the agency in charge of privatization should defray its costs, including the cost of operating the agency, prior restructuring (and in particular debt write-offs resulting from restructuring of SOE balance sheets), payment of advisers and other transaction costs. Funding for these expenditures is normally provided by the general budget, a special privatization account set up as described above and/or the grant of borrowing authority.

Finally, in some instances, the law also authorizes the waiver of moneys due to the State by the SOE. Article 32 of the Tunisian privatization law No. 89-9, for example, authorizes the prime minister to waive the State's privileged creditor status in the context of pre-divestiture SOE restructuring. In exchange for this waiver, the State may ask the SOE's beneficiary creditors to cancel or restructure part of their own claims. Article 30 of the same law allows very generous tax benefits for privatized enterprises, including exemptions from corporate profit taxes and capital gains taxes. Other examples of such provisions may be found in the Philippines²²³ and other countries.

Restrictions on Divestiture

The divestiture law should not include any unnecessary restrictions. National interests or government objectives (including industrial policy objectives) are reflected in some laws, however, most often through safeguards against foreign control over divested SOEs, sometimes combined with non-price selection factors.

Golden shares have been used in this context by some countries, including France²²⁴, UK²²⁵,

²²² Allocation of privatization proceeds was a major problem in Brazil, where the government's privatization program focused in a first phase on the steel, fertilizer and petrochemical sectors. Petrobras, the majority shareholder of Petrofertil and Petroquisa (the sub-holdings for the fertilizer and petrochemical sectors, respectively), felt that it, rather than the Treasury, should receive the proceeds. In addition, a group of minority shareholders in the petrochemical sector went to court to block the privatization. See Financial Times, November 7, 1990, p. 6.

²²³ Section 35 of the privatization law exempts the Asset Privatization Trust from any taxes or official charges resulting from the passing of title to assets transferred to the Trust or from the Trust to private purchasers. The section also exempts such title transfers from any impediments that could be occasioned by pre-existing tax liens on the transferred property, provided that the proceeds of the sale would first be applied to pay off these liens.

²²⁴ Article 10 of the French privatization law of August 6, 1986, authorizes the minister of the economy (i) to determine in the case of each of the 65 companies to be divested whether the protection of national interests requires that a special share be granted to the State, and (ii) if so, to establish such share. Company by-laws then have to be amended accordingly. "The special share enables the minister of the economy to vet any shareholding by one person or group of persons acting together exceeding 10% of the capital. The minister of the economy may permanently convert the special share into a normal share at any time. This will happen automatically after five years." People acquiring shareholdings in violation of these provisions, will have their voting rights suspended and are under the obligation to resell such shares within three months. In practice, however, the Minister rarely used his powers to create a golden share and most SOEs were privatized without such share. Other legislation existing at the time gave the government the power to control and sometimes block unwanted take-overs. See Graham and Prosser (1990) at p. 154.

²²⁵ Most (though not all) UK privatizations included a golden share feature which was incorporated in the concerned company's by-laws (articles of agreement). In the British Airports Authority case, for example, the disposal of an airport is subject to the approval of the special shareholder. In general, the special share granted the State the right to intervene to block take-overs and/or foreign involvement.

New Zealand²²⁶, Turkey (Teletas), Brazil (Celma), Malaysia (MAS), and Senegal²²⁷, to exert control over divested SOEs. Golden shares are special shares created either by law or company statutes with the specific purpose of granting their holder (the government) special rights that go well beyond rights attached to ordinary shares. They are kept by the government for some time after the divestiture of the government's ordinary shares and have to be described in the prospectus for the sale of such ordinary shares.²²⁸ These special shares have been featured to give the government the right to control future share transfers in divested airlines, for example, as the authority to fly international routes is based on bilateral treaties which benefit national airlines, a term often defined as airlines majority-owned²²⁹ by nationals of the signatory country.

Golden shares are in no way essential features of privatization laws. To the contrary, by barring the normal operation of the market and blocking some types of take-overs (the most frequent purpose of golden shares), they may reduce management incentives and performance in the privatized companies.

In other countries, explicit restrictions on foreign bidding for SOEs or shares of privatized enterprises were included in the law²³⁰, or ceilings were set on foreign ownership²³¹.

²²⁶ The by-laws of Air New Zealand and Telecom were amended to allow the retention of a "Kiwi share" with special rights (i.e. a golden share) by the State.

²²⁷ In Senegal, the privatization law authorizes the use of a golden share in limited circumstances, primarily to protect the government's interests as a creditor in enterprises divested with loan or guarantee obligations vis-a-vis the State. Article 14 of the law stipulates that the "Minister in charge of the State's Portfolio may decide by issuing an "arrêté" (ministerial decision) that one of the shares held by the State in an enterprise to-be-privatized which has previously received loans guaranteed or on-lent by the State, may be transformed into a special share carrying particular rights. (...) The special share allows the Minister in charge of the State's Portfolio, under the conditions and subject to the modalities set forth by [presidential] decree, to ensure that all dispositions have been taken by the enterprise to reimburse its loans guaranteed or on-lent by the State."

²²⁸ The 1984 prospectus for the sale of shares in British Telecommunications Plc described the rights attached to the golden share, namely: (i) attend and speak at shareholders meetings; (ii) appoint up to two directors with voting rights on issues of concern to the government; (iii) though no right to participate in capital or profits; (iv) one pound redemption value. Similar provisions may be found in the 1988 prospectus for British Gas Plc, except for the right to appoint directors; in addition the government's approval must be sought in writing to amend some provisions of the company's articles of association, in particular the one prohibiting any person from owning more than 15% of the company's capital. The 1987 prospectus for British Airways Plc describes how the special shares will *inter alia* limit the right of foreigners to buy shares of the company, as foreign control could lead to a loss of the right to operate international routes.

²²⁹ The minimum percentage of national ownership required may vary.

²³⁰ Article 3 of the CSFR Small Privatization Law of 1990 stipulates that only CSFR nationals and companies or other legal entities in which all owners or members are nationals can become owners of the enterprises or assets privatized under this law.

²³¹ Article 13 of Brazil's law No. 8031 of 1990 sets this ceiling at 40% of voting power. For the purposes of the law, a company incorporated in Brazil would be considered as foreign if it is controlled by foreigners. In addition, a requirement was initially introduced that the funds invested in the privatization program by foreigners using debt-equity swaps must remain in Brazil for at least twelve years, the participation in a privatized company acquired with these funds must be held for at least two years during which the foreign investor would not be allowed to repatriate any funds. These additional restrictions were later lifted, however. (Source: Financial Times, April 5, 1991, and January 21, 1992, p.24; and, Legal Letter, Pinheiro Neto - Advogados, August 1991) "The Brazilian government has adopted the new rules because of disappointment over foreigners' poor showing in the first few privatization auctions". "'We hope the easing of regulations on foreign investment will stimulate foreigners' interest in Brazilian privatisation,' said Mr Ricardo Figueiro, chief of staff for the privatisation support programme at the National Development Bank." (Financial Times, December 30, 1991, p.15).

As a general rule, the more constraints, objectives or restrictions are introduced in the law, the harder the privatization will be. Restrictions have a cost in terms of price or efficiency and can often be circumvented. Restrictions relating to the identity of the buyer can be circumvented through the use of front men, for example, and restrictions on secondary sales tend to be hard to enforce. Some of the more common restrictions, such as golden shares or employee rights, have already been outlined above.

Additional restrictions may pertain to the time period during which the government is authorized to divest (these restrictions may impair a government's bargaining position in negotiations with potential buyers) or limit the management freedom of new owners of the divested company, e.g. restrictions on future labor lay-offs. In the latter context, the president of the Karachi stock exchange was quoted as saying that the requirement that workers should not be laid off during an initial 12-month period is discouraging businessmen who might otherwise be interested in bidding for companies.²³²

Some restrictions may contribute to the objectives of the privatization program, however. In order to effectively reduce the public sector's role in the economy, a number of countries, such as Brazil²³³, Russia²³⁴ and Bulgaria²³⁵, have limited SOEs' ability to participate in the privatization process as buyers.

Transitional and Interim Provisions

Because privatization programs involve time-consuming and drawn out processes, interim measures are often adopted to manage assets while awaiting final divestiture. Such provisions typically address questions relating to: (i) the asset or the SOE being divested, including management changes, transitional regime for SOE privileges, etc.; (ii) the status of employees of former SOEs, including pre-divestiture lay-offs; (iii) the liquidation of the SOE shell remaining after corporatization or divestiture through sale of assets; (iv) the disposal of obligations remaining with the State; and (v) the allocation of SOE revenues accruing during the interim period.²³⁶ They are commonly found in enterprise or sector-specific legislation in situations requiring restructuring of the SOE(s) prior to divestiture.²³⁷

²³² Financial Times, 08/05/91.

²³³ The directive committee set up pursuant to the privatization law issued a resolution No. 15 on August 19, 1991, setting an overall ceiling of 15% on shares in a privatized enterprise that may be acquired by SOEs.

²³⁴ Article 9 of the privatization law provides that entities having public shareholders with more than 25% of the share capital may not be buyers of privatized enterprises.

²³⁵ Paragraph 4 of article 5 of the privatization law provides that public bodies and enterprises with more than 50% state or municipal ownership may not participate in the privatization process unless they are specifically authorized in writing in each case by the Privatization Agency.

²³⁶ See, for example, the Philippines Presidential Proclamation 50 of 1986, which contains several provisions intended to answer interim concerns. Section 29 provides that the management of assets during the transitional period preceding divestiture shall be handled by the government institution previously responsible for such assets under terms and conditions agreed with the national government.

²³⁷ The UK Electricity Act 1989, for example, includes transitional provisions relating to the restructuring of the power sector assets under newly established successor companies that would in turn be privatized, and to the way in which the State may interact with these successor companies while they are wholly owned by the Crown.

Concluding Remarks

A divestiture law does not need to cover all of the items listed in this chapter. As a matter of fact, a law may not even be required to carry out privatization. Where required, the law should be clear and to the point, and leave implementation details to subordinated legal instruments.

Indeed, whereas one could argue that all critical aspects of a proposed divestiture program should be addressed in the government's divestiture strategy, the same could not be said about the divestiture legislation. The necessity of a divestiture law must first be established on the basis of an analysis of the legal implications of the divestiture strategy and program and the status of the country's legislation. In addition, political considerations may also plead for a law, even where this is not needed from a strictly legal point of view. As a result, if a law is indeed deemed necessary or desirable, its contents are bound to differ greatly from country to country.

As a general rule, we recommend that, where a law is indeed needed, its provisions be limited to the minimum strictly required to privatize efficiently. What can already be done under existing laws and regulations (including constitutional requirements) should be done so and should not be repeated in a new law. New legislation would be warranted to accommodate what cannot be undertaken, or at least not undertaken efficiently, under the existing legal framework. We would further suggest that what can be done as well or better through lower instruments be handled at such lower levels. This includes not only subordinated or secondary legal instruments, such as implementing regulations, guidelines and decisions, but also contractual agreements negotiated with the buyers. This implies that the divestiture law itself be a broad enabling law, giving the government or privatization agency the powers to privatize, without getting into any great detail about how this should be done. Divestiture laws should to the extent possible avoid restrictions that might unduly tie the implementing agencies' hands and delay the privatization process.

The legal framework for divestiture, whether it includes specific legislation or not, should be flexible. Indeed, one cannot anticipate all situations and problems that might arise during the implementation of a divestiture program. A flexible legal framework will enable the government or responsible agencies to adapt their approaches to changing circumstances. A rigid framework is likely to result in slow progress, ineffective methods and poor overall results.

Finally, one should beware of "legislative optimism". Even if one assumes that the legislator could correctly anticipate the major issues that would arise as part of the implementation of the divestiture program and could thus design an optimal legal framework for divestiture, this would by itself not guarantee success. This legal framework would still need to be applied effectively, which requires that the necessary institutions and capacity exist or be developed and that the individual transactions be prepared, structured, negotiated and implemented with competence and integrity.

CHAPTER IV. THE ROLE OF LAWYERS IN DIVESTITURE

This paper has illustrated the dominant aspect of legal issues in the development and implementation of a successful divestiture program. Legal inputs are required to analyze the existing business environment, identify potential bottlenecks to privatization and find ways to remove such bottlenecks. Lawyers' inputs become even more important at the transactional level, where they often play a lead role in structuring and negotiating the deal. Government officials, SOE managers and donor agency staff should be aware of the critical need to retain qualified and experienced lawyers who fully measure up to the demands and complexities of these tasks.²³⁸

Three categories of lawyers are involved in privatizations, namely public sector lawyers (government or SOE lawyers), outside lawyers advising the government, SOE or buyers (local and foreign lawyers), and lawyers of international financial institutions advising the country or SOE on privatization policy (e.g. World Bank lawyers). Governments and SOEs rarely have in-house legal staff with relevant qualifications and experience in divestiture. This tends to be true in industrialized as well as developing countries. As a result, countries as diverse as the UK, New Zealand, France, Germany, Argentina, Côte d'Ivoire and many Eastern European countries have contracted out a large part of their legal privatization work to private law firms or legal consultants.

Although some legal advisers may have the qualifications and experience to provide full-service legal advice throughout the whole divestiture process, by and large, different skills are called for in the preparation of an overall program and the implementation of divestiture transactions.

In the preparatory phase, lawyers need to have a good understanding of policy issues, including their economic and political implications. As their advice feeds into the strategy formulation, they need to be very sensitive to local conditions and constraints. When assessing the overall enabling environment for business activity and specific legal requirements for divestiture, as described in earlier chapters of this paper, legal advisers will usually need to take an empirical and inductive approach, starting with the identification of day-to-day constraints hampering private businesses or restricting the government in its divestiture mode. Indeed, as pointed out earlier, one should not attempt to have a perfect legal environment in place prior to the start of actual divestitures. Such approach would result in endless delays and eventually doom the whole divestiture process.

To the contrary, the legal reform strategy should be pragmatic and built on the removal of existing bottlenecks and restrictions, starting with the most binding ones. This may mean, for example, that a less than perfect investment code would not be amended if its imperfections are not assessed as a deterrent to investment. The more theoretical or deductive approach, which may come more naturally to many lawyers, would start with a review of all major laws and recommend changes in such laws to bring them up to international standards. This approach may miss the real legal issues facing divestiture in the specific country, such as weak implementation and enforcement of laws, customary practices not

²³⁸ "Qualified and experienced legal counsel should be able to identify and anticipate obstacles, both legal and non-legal, and, more importantly, devise ways to get around such obstacles and achieve the desired objective. Legal advisors that merely identify obstacles are of little value and, indeed, may be counter-productive in transactions of the complexity of most privatizations." Quale (1991), p. 25.

codified by law, or legal restrictions embedded in unusual laws or regulations, to name but a few. Lawyers involved at the strategy development stage should thus have an acute sense of business realities and political, administrative and other constraints in the divesting country. They will always need to work closely together with other, non-legal advisers involved at that stage.

At the transaction level, a law firm should normally be retained to represent the government, especially in cases where a large or strategic enterprise is to be sold. The work is likely to be intensive and to demand a wide range of legal skills. There are many law firms worldwide with extensive privatization experience, including experience in several countries. The selected law firm should preferably have relevant experience in the concerned sector. This is particularly important in telecommunications or power sector divestitures, for example, where sector-specific issues and legal and regulatory arrangements prevail. It may also be desirable for the enterprise itself to retain its own legal advisers, particularly if the transaction is one whereby only part of the assets of the enterprise will be sold²³⁹. In either circumstance, the role of the outside legal advisers is to represent the interests of the seller and to ensure that the seller's objectives are met to the maximum extent and its interests are fully protected. Privatization of large enterprises are amongst the most significant and complex commercial transactions which a government is likely to undertake. Also, as private buyers will often be assisted by high-powered lawyers in the negotiation of a transaction, the seller should benefit from an equivalent quality of legal advice.

While the cost of engaging outside legal advisers may seem high, the benefits of doing so should by far outweigh such cost. Whether for general advisory work or for transactional services, lawyers (and other advisers) should normally be retained through a competitive process. Care must be taken in the recruitment of outside legal advisers to ensure that conflicts of interest do not arise. A conflict of interest would weaken the lawyers' ability to provide independent advice. For instance, investment bankers and lawyers advising governments or SOEs on divestiture transactions should normally not be retained as teams, but rather separately. Indeed, government or SOE lawyers should be accountable to the seller (the government or SOE) and not to his advisers (the investment bank). As part of their duties, the lawyers may have to advise the government in the negotiation of an advisory contract with the investment bank or in the enforcement of such contract²⁴⁰. This role may not be undertaken in an independent and impartial way, where the lawyers are sub-contractors or joint venture partners of the investment bank. Furthermore, the different obligations of these two groups of advisors are usually reflected in a different compensation scheme. Finally, the government would normally benefit from two different advisors with different points of view on the divestiture transaction.²⁴¹ If called to advise on general privatization strategy and legislation, however, such conflicts of interest are unlikely to arise. To the contrary, integrated multi-disciplinary teams of lawyers and other consultants may be better equipped to advise the government on a comprehensive divestiture strategy and action plan.

²³⁹ In this case, the SOE, as seller of part of its assets, has an interest in the transaction which is independent of the interest of the State as the owner of the SOE.

²⁴⁰ The investment bankers may also have conflicts of interest, which the lawyers should bring to the attention of their client. An example of such conflict is where the same bank acts as general financial adviser of the government for the privatization transaction and simultaneously as underwriter for the transaction. *See*, for example, Graham and Prosser (1991) at p. 92.

²⁴¹ It would not be untypical to have either the lawyers or investment bankers selected first and then assisting the government in the selection of the other group, however.

It is not uncommon to find local and foreign law firms working together on privatization matters, the local firm bringing the knowledge of the country, its courts and business practices, the foreign firm the experience of similar transactions in other countries. In fact, divestiture tends to stimulate the demand for advice from local private legal practitioners in substantive areas of business law in which they had not been able to gain much experience. As local lawyers in many countries are unlikely to be familiar with the technicalities of divestiture transactions, training and development programs may need to be organized. Such programs should address the needs of the local legal community and provide them with the necessary skills to become effective participants in the implementation of the privatization process.

The World Bank can assist privatizing governments in the selection and financing of expert counsel. Where necessary, funding for legal assistance and for other advisory services can be obtained from the World Bank or other donor agencies. Even in the absence of such outside funding, the concerned governments would be well advised to use their own resources to retain good lawyers. World Bank lawyers can be of help in the preparation and implementation of divestiture programs, including preparation of terms of reference for and supervision of legal advisers hired under World Bank-supported projects. They should not, however, be asked to act as primary legal advisers to governments or SOEs.

In summary, the range and complexity of legal issues that could arise in privatization programs is almost endless. In each country, and for each significant transaction, privatizing governments should retain the services of qualified, experienced and independent lawyers to help them in identifying and addressing the critical legal issues arising at all stages of the process, from design to implementation and follow-up. Lawyers should facilitate the divestiture process by identifying constraints before they become binding and suggesting ways to remove or alleviate such constraints. Legal advice is also needed to safeguard the interests of the seller in the negotiation and conclusion of important divestiture transactions. As law is only one of the many facets of divestiture, lawyers will need to work closely with advisers and officials from other disciplines. Divestiture is a complex, multidisciplinary exercise requiring close cooperation between economists, financial advisers, lawyers and other experts.

LIST OF PRIVATIZATION LEGISLATION¹

- Albania Law No. 7512 Permitting and Protecting Private Ownership, Free Initiative, Independent Private Activities, and Privatization (10 August 1991).
- Decree No. 22 promulgating Law No. 7512 (15 August 1991).
- Council of Ministers Decision No. 307 on Duties and Rights of the National Privatization Agency and the Commission for the Preparation of the Privatization Process (29 August 1991).
- Council of Ministers Instruction No. 3 on Organization of Work and Realization of the Transition from State Ownership to Private Ownership through Auctions (30 August 1991).
- Argentina Law No. 22177 (4 March 1980).
- Law No. 23696 on State Reform (18 August 1989).
- Law No. 23697 on Economic Emergency (15 September 1989).
- Law No. 24045 (1992).
- Law No. 24076 on the privatization of Gas del Estado (June 1992).
- Decrees Nos. 575/90, 1105/90, and 1948/90 (1990); 2515/91 (1991); 51/92, 214/92, 839/92, 999/92 and 2514/92 (1992).
- Armenia Decree of the Supreme Soviet on the Principles of Privatization (1991).
- Bolivia Supreme Decree No. 21060 (29 August 1985).
- Supreme Decree No. 22836 (June 1991).
- Law on privatization (May 1992).
- Supreme Decree 23170 on the implementation of the privatization law (June 1992).

¹ This list is in no way exhaustive. It includes laws and regulations currently in force, as well as laws and regulations that have since been abrogated or amended. Complete citations are provided whenever available. Some of the references were culled from the literature and may not be accurate. In addition, as of this writing a large number of countries, including Benin, Guinea, Guinea-Bissau and Zambia, were in the process of adopting privatization laws.

- Brazil
- Decree No. 91991 (28 November 1985).
 - Decree No. 95886 on the Federal Destatization Program (29 March 1988).
 - Law No. 8018 on Privatization Certificates (11 April 1990).
 - Law No. 8031 authorizing the National Denationalization Program (12 April 1990).
 - Decree No. 99463 appointing BNDES for the Implementation of the PND (16 August 1990).
 - Decree No. 99464 on the Privatization of Usiminas (16 August 1990).
 - Provisional Measure No. 299 interpreting Law No. 8,031 of April 12, 1990 (19 October 1991).
 - Law No. 6629 Authorizing the Executive of the Sao Paulo State to Transfer Shareholding Control of Viacao Aerea Sao Paulo S/A (27 December 1989).
- Bulgaria
- Decree No. 36 on the Development of Private and Personal Initiative in Commerce, Tourism and Services (10 April 1990).
 - Decree No. 42 on the Adoption of Regulations for Auctioning State and Municipal Property (14 March 1991).
 - Law on Transformation and Privatization of State and Municipal Enterprises (23 April 1992).
- Burkina Faso
- Ordinance No. 91-0044 Authorizing the Privatization of 12 Enterprises and creating a Privatization Commission (17 July 1991).
 - Decree No. 91-0385 setting forth the Composition, Organization and Operations of the Privatization Commission (26 September 1991).
- Burundi
- Decree No. 1/21 on Privatization of State-owned Enterprises (12 August 1991).
 - Ordinance No. 120/321 setting Modalities for Competitive Bidding for the Privatization of State-owned Enterprises (4 October 1991).
- Canada
- Financial Administration Act (1984).
 - Teleglobe Canada Reorganization and Divestiture Act 1987.
 - Petro-Canada Public Participation Act (January 1990).
 - Nordion and Theratronics Divestiture Authorization Act (30 January 1990).

- Chile General Law of Electricity Services, Decree-Law No. 1 (22 June 1982).
- General Telecommunications Law No. 18168 (2 October 1982), amended in 1987.
- Czechoslovakia
(CSFR) Law on Private Enterprise by Citizens (and supplement) (1 May 1990).
- Law on the Transfers of State Property of some Goods to other Juristic or Natural Persons - "Small Privatization Law" (25 October 1990).
- Law intended to Redress Results of Injustices arising during 1948-89 - "Extra-judicial Rehabilitation Law (Restitution Law)" (21 February 1991).
- Law No. 92/1991 on the Conditions of Transfer of State-Owned Assets to Other Persons - "Large Privatization Law" (26 February 1991).
- Law Amending the Large Privatization Law (February 28, 1992).
- CSFR Government Decree on the Issue and Use of Investment Coupons (5 September 1991).
- Czech National Council Law No. 171/1991 on the Jurisdiction of the Agencies of the Czech Republic in matters of Transferring State-Owned Assets to Other Persons and on the National Assets Fund of the Czech Republic (23 April 1991).
- Slovak National Council Law No. 253/1991 on the Jurisdiction of the Agencies of the Slovak Republic in matters of Transferring State-Owned Assets to Other Persons and on the National Assets Fund of the Slovak Republic (1991).
- Egypt Law No. 230 on joint-venture companies (1989).
- Law No. 203 on Public-Sector Business Enterprises (1991).
- Prime Minister Decree No. 1590/1991 on the implementing regulations for law No. 203/1991 (1991).
- France Law No. 86-793 Authorizing the Government to take Diverse Economic and Social Measures (2 July 1986).
- Law No. 86-912 relative to the Modalities of Application of Privatizations decided by Law No. 86-793 (6 August 1986).
- Decree on Nomination of the 7 Members of the Privatization Commission (9 September 1986).
- Decree No. 86-1140 on the Application of Law No. 86-912 of August 6, 1986 (24 October 1986).

Decree No. 86-1141 on the Application of Article 10 of Law No. 86-912 of August 6, 1986, relative to the Modalities of Implementing Privatizations (25 October 1986).

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Soviet Union	Law on the Principles of Denationalization and Privatization of Enterprises (July 1, 1991).
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³ This law was abrogated by law No. 89-9.

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LEXICON¹

abrogate (to)	To annul or repeal (an existing law, executive order or other legal instrument).
act (legislative)	The term "act" is often used as abbreviation for "legislative act" or "act of Parliament" and is a synonym for "law".
auction	"An auction is a public sale of property to the highest bidder by one licensed and authorized for that purpose." (Black's ²)
bankruptcy	Court-supervised liquidation procedure. Bankruptcy may typically be initiated by the company, its creditors or other parties.
bid; bidding	A quotation setting forth the price that someone (the bidder) is willing to pay for an asset or share.
bilateral agreement	Equivalent to a contract. Often used to refer to agreements between two sovereign nations (e.g. double taxation avoidance treaties, mutual investment treaties).
build-operate and transfer (BOT)	Contract by which one party (typically, a private consortium) agrees to build, finance the construction, operate and maintain a facility (e.g. factory, public infrastructure) for a specified period of time, and then transfer the facility to the other party (typically, the State). A BOT is in essence a concession contract.
by-laws	"Regulations, ordinances, rules or laws adopted by an association or corporation or the like for its government". (Black's)
collateral	Property which is pledged as security for the repayment of a debt.
commercialization	Introduction of commercial objectives into the management and operations of an SOE. Commercialization does usually not imply a change in legal status. <u>see</u> also corporatization.

¹ The definitions provided in this annex are for the readers' convenience only. They are in many instances not precise legal definitions, and may not reflect the different meanings a term may have.

² References to Black's are to the Fifth Edition of Black's Law Dictionary, West Publishing Company, St. Paul Minn., 1979.

company	A legal entity created by stockholders (whether individuals, companies or other legal entities) to carry on business activities, which exists independently of such stockholders.
compensation	The act of giving indemnification, making whole, giving back an equivalent or substitute of equal value. (Black's) Monetary compensation paid to a (previous) owner for property taken by the State (<u>see</u> confiscation and expropriation).
concession	A contractual arrangement between the State (or other public entity) and a private operator (called a concessionaire) requiring the latter to build (and finance the construction of) public works, such as a road or water supply system, in the general interest. In exchange, the State grants the concessionaire the right to operate for a specified period of time and at its own risk the infrastructure and to charge users. A concession of this type is similar to a BOT agreement. Other forms of concessions include concessions to provide a public service on the basis of existing infrastructure, and mining concessions.
condemnation	Process of taking private property for public use through the power of eminent domain. (Black's) Many constitutions require that "just compensation" be paid if property is condemned. <u>See</u> also confiscation and expropriation.
confiscation	Seizure of private property from their owners without compensation. Confiscation is sometimes the result of a criminal conviction of the property owner or because the use or possession of the property was contrary to a law.
contract of adhesion	Agreements that must be entered into or rejected by a party without the opportunity to negotiate or vary any aspects thereof (e.g. a public offering of securities, a contract between a utility and its clients/users).
corporation	A legal entity created by or under the laws of a state (Black's). Normally classified either as a public corporation, created and owned by the State or another public body, or a private corporation, created by private persons for private purposes.
corporatization	The transformation of a State-owned enterprise or business asset into a public corporation organized under the companies law. Often also the first step in the privatization of an SOE.
decree	An executive order, which is usually subordinated to a law. Secondary or derived legislation, as opposed to primary legislation (i.e. law enacted by the legislature). Depending on the legal regime, decrees may be issued by the President, the Council of Ministers, the Prime Minister or another cabinet member.
demonopolization	The process of undoing or breaking up a monopoly. <u>See</u> monopoly.

deregulation	The act or process of removing restrictions or regulations.
disinvestment	Process inverse to the act of investing; action leading to the end or winding up of an investment. <u>See</u> divestiture and divestment.
dissolution	The termination and winding up of a corporate or public entity's life. <u>See</u> also liquidation.
divestiture	Transfer of public or State-owned property (including SOEs) to the private sector.
divestment	Defined by the Dictionary of Economics as "The liquidation or sale of parts of a firm. Divestment is, in effect, the opposite of acquisition or merger." Black's Law Dictionary defines divestment as "in [US] property law, the cutting short of an interest prior to its normal termination".
enabling legislation	Legislation giving the government (or another person or body) the power to do something it could not do otherwise. In the divestiture context, legislation authorizing the government to divest. In the broader PSD context, legislation removing constraints imposed on the private sector.
expropriation	The action whereby a State takes or modifies the property rights of an individual or business entity against compensation in the exercise of the State's sovereignty. <u>See</u> condemnation, confiscation.
foreign exchange	
allocation	Allotment or assignment of right to exchange specified sums of local currency into foreign currencies under certain conditions.
convertibility	Ability of a certain currency to be freely exchanged for (i.e. converted into) other currencies.
repatriation	The return by a foreign investor of his capital and/or profits out of the country of investment.
going concern	An enterprise considered as an economic unit, an operational entity. In the sale of an enterprise as a going concern, the enterprise would typically be expected to continue transacting its normal business. This may be done even if the ownership of the legal entity is not transferred as such.
golden share	Special share of stock with special powers allowing its holder (the State) to exercise specified exceptional rights with respect to the conduct of business of a divested SOE.
initial offering	First offering of shares of a company on the market.

insolvency	The state of a person (legal entity or physical person) "unable to pay debts as they fall due in the usual course of business; <i>specif.</i> having liabilities in excess of a reasonable market value of assets held" (Webster's).
inter alia	Latin term, meaning: amongst other, including.
joint stock company	A company having a joint stock or capital which is divided into units of ownership interest such as shares. Equivalent to the French 'Société Anonyme' or the German 'Aktiengesellschaft' (AG). <u>See</u> company, corporation.
joint venture	"An association of persons jointly undertaking some commercial enterprise." (Black's) A joint venture may or may not be incorporated. The participants accept duties to one another to act in good faith. A joint venture agreement will often define their business relationships. This term is sometimes also used to refer to a company established jointly by the State and private partners, or by domestic and foreign partners.
juridical person	A person or entity with separate existence under law. Equivalent to legal entity.
lease	A contract whereby the owner of an asset (or enterprise), the lessor, provides the other party, the lessee, with the possession of and profits from such asset during a set period of time. A lease does not transfer ownership of property, unless it is accompanied by a purchase option which is exercised.
legislation	Used in a narrow sense, this term refers to laws, i.e. acts of the legislature. In a broad sense, and in particular in civil law countries, it refers to laws as well as derived or secondary legal instruments (e.g. decrees, executive orders).
liability	Includes "almost every character of hazard or responsibility, absolute, contingent, or likely". (Black's). All the claims against a business enterprise, including wages or salaries, amounts due suppliers, dividends declared payable, taxes, long and short term obligations such as bonds and bank loans, etc. A liability is contingent when its existence depends on an unknown or future event, such as the outcome of litigation or the occurrence of environmental damage.
limited liability company	A company in which the owners (stockholders) are liable for the debts of the company only up to the amount of capital contributed by them into the company. In some countries, this term refers to a type of company that has fewer incorporation and legal requirements than joint stock companies (equivalent in this sense to the French SARL or the German Gmbh).

liquidation	"Winding up of corporation so that assets are distributed to those entitled to receive them. Process of reducing assets to cash, discharging liabilities and dividing surplus or loss. ... It is to be distinguished from dissolution which is the end of the legal existence of a corporation. Liquidation may precede or follow dissolution, depending on statutes." (Black's) <u>See</u> also Bankruptcy.
monopoly	A privilege or peculiar advantage vested in one person or business entity, conferring upon them the exclusive right or power to conduct a certain activity or trade, or to control the supply or sale of a particular good or utility to a "captive" market. (Black's) A legal monopoly is granted and protected by law (as opposed to a <u>de facto</u> monopoly).
nationalization	Confiscation, expropriation, forced acquisition of a private enterprise or asset by the State, often pursuant to a nationalization law.
offering	"An issue of securities offered for sale to the public or to a private group." (Black's) <u>see</u> also initial offering, primary offering, secondary offering, private offering and public offering.
ownership	Black's definitions of ownership include: "collection of rights to use and enjoy property, including right to transmit it to others", "the right of one or more persons to possess and use a thing to the exclusion of others", and "the exclusive right of possession, enjoyment and disposal; involving as an essential attribute the right to control, handle and dispose". <u>See</u> property.
pre-emptive right	Right, typically of a shareholder, to buy shares before they are offered to others.
primary offering	An issue of new shares or securities by a company, typically in the case of a capital increase; proceeds of the offering go to the issuing company.
private company	In this paper, a company owned by private parties (individuals or legal entities), and not by the State or another public body. A company with mixed ownership (some private and some public owners) may be considered a private company if the public sector owns less than a controlling interest in it. To be contrasted from a public enterprise or SOE, which are owned and controlled by a State or other public entity. <u>See</u> public company.
private placement or private offering	An offering made only to a limited number of persons and not to the public at large. Securities laws may or may not regulate such offerings.
private sale	"One negotiated and concluded privately between buyer and seller, and not made by advertisement and public notice or auction or through a broker or agent." (Black's)

privatization	Any measure resulting in the transfer of ownership and/or control over assets or activities from the public to the private sector. This term is much broader than divestiture. <u>See</u> also pp. 1-2 of this paper.
property	Black's definitions of property include: "ownership; the unrestricted and exclusive right to a thing; the right to dispose of a thing in every legal way, to possess it, to use it, and to exclude everyone else from interfering with it", and "the exclusive right of possessing, enjoying, and disposing of a thing". <u>See</u> ownership
PSD	Private sector development.
public	This adjective has two main meanings in the context of this paper. It usually refers either to public as something related to the State or its instrumentalities, as in the case of public sector, public enterprise and public corporation, or to something related to the population at large (the public), as in the case of public company and public offering. This may create some confusion: a public company, for example, is not a company owned by the public sector, whereas a public enterprise is an enterprise owned by the public sector.
public company	A company whose shares are held by the public or a group of persons who do not otherwise have a common business interest. The shares are often traded on a securities market.
public domain	That which belongs to the public at-large, and is open to common use (Black's) without necessitating the payment of any usage fees or royalties. In France, and in countries with legal systems that follow the French civil law, the State's public domain refers to State-owned property that is dedicated to public use and enjoyment. Public domain property is usually difficult to privatize, often requiring prior legislative intervention. By contrast, the State's private domain property can be more easily alienated.
public enterprise	Enterprise owned by the public sector. This term includes SOEs, as well as enterprises owned by other SOEs, municipalities or other public bodies.
public offering	An offering of stock or securities to the public at large, in which any member of the public may participate, as opposed to a "private" offering or placement. Public offerings are generally regulated by law.
restitution	Act of restoring or returning something to its rightful owner. Differs from compensation in that the confiscated item is returned to its rightful owner.
secondary market	Financial market in which securities can be traded after their initial offering.
secondary offering	An offering of a large block of existing stock in a company, where the proceeds of the sale go to the owner-seller of the stock, i.e. typically to the government in the case of SOE divestiture. As opposed to "primary offerings" which are issues of new stock.

security/ies	"Stocks, bonds, notes, convertible debentures, warrants, or other documents that represent a share in a company or a debt owed by a company." (Black's)
self-management	Socialist SOE management scheme under which employees and management of an SOE exercise the ownership rights of the State in their enterprise.
SOE	State-owned enterprise. Often used interchangeably with public enterprise.
State holding company	SOE confining its activities to the ownership and holding of other companies (typically, though not necessarily, SOEs) and to the management and control thereof.
statute	Law, act of parliament (as opposed to court-made law).
tender (to)	To make a bid.
tender offer	A bid or offer (usually stated in monetary terms) for the purchase of shares or assets. It often constitutes the basis for negotiations with the seller. Tenders may be open to all investors or limited to a specified category or group of qualified or pre-selected investors.
tender conditions	Seller's general conditions defining the terms under which interested parties may make an offer for the purchase of the shares or assets to be sold (or for the supply of goods or services).
transformation	In the context of SOE reform, refers to the change of an SOE from one legal status (e.g. statutory corporation) to another (e.g. company organized under company law). <u>See</u> also corporatization.
ultra vires actions	Acts beyond the scope of one's defined powers or prerogatives. In corporate law, refers to unauthorized actions by a corporation, its executives or members of its board of directors.
underwriters	Generally, any person or company that purchases an issuer's or seller's securities for resale. An underwriter assumes the risks associated with the resale of a security, such as the one that the security will be undersubscribed, or that it will not sell for the anticipated price.
vouchers	A coupon, form or other document indicating that its owner may apply the amount specified on the voucher against future purchases or acquisitions of certain items, such as shares in former SOEs, or State assets.

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